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86-1119

No. .....

In The
# Supreme Court of the United States
October Term, 1986

RICHARD DRAYTON, JOHN R. SAUERTEIG AND SYDNEY G. STEVENS, as escrow agents of THE DELAWARE AND BOUND BROOK RAILROAD COMPANY,

*Petitioners,*

-v.-

THE UNITED STATES OF AMERICA,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI FROM THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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## QUESTION PRESENTED FOR REVIEW

Whether the interest component of Certificates of Value given by the United States Railway Association to railroad tranferors in exchange for rail properties conveyed to Consolidated Rail Corporation constitutes ordinary income taxable under I.R.C. 26 U.S.C. § 61(a), as the United States Court of Appeals for the Third Circuit held, or whether the interest component constitutes proceeds from the sale or exchange of a capital asset as held by the federal district court for the District of New Jersey.

## PARTIES TO THE PROCEEDING IN THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

All parties to the proceeding are set forth in the caption of this case.

Counsel notes, however, that the issue presented before this Court will have a material impact on similarly situated railroads who have transferred their rail properties to the Consolidated Rail Corporation pursuant to the Rail Reorganization Act of 1973.

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## OPINIONS BELOW

The decision of the United States District Court for the District of New Jersey granting summary judgment in favor of the Petitioners is reported at 632 F.Supp. 95 (D.N.J. 1985).

The opinion of the United States Court of Appeals for the Third Circuit vacating and reversing the judgment of the district court is reported at 801 F.2d 117 (3d Cir. 1986).

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## JURISDICTIONAL STATEMENT

The Third Circuit entered its judgment on September 11, 1986. A petition for rehearing and rehearing *en banc* was timely filed by the Petitioners on September 25, 1986.

Petitioners' request for rehearing and rehearing *en banc* was denied on October 7, 1986. (App. 43).

Jurisdiction is invoked pursuant to 28 U.S.C. §1254(1).

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## STATUTORY PROVISIONS INVOLVED

The issues presented in this Petition involve the Rail Reorganization Act of 1973 and the amendments thereto.

This Petition involves 45 U.S.C. § 746 and 26 U.S.C. § 374(a) and (c).

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## STATEMENT OF THE CASE

The Petitioners are the successors-in-interest of The Delaware and Bound Brook Railroad Company (the "D&BB"). The D&BB was a railroad corporation organized and existing under the laws of the State of New Jersey (A.9).[1]

As a railroad corporation, the D&BB was directly affected by the Regional Rail Reorganization Act of 1973,[2] a statute providing for the rehabilitation and reorganization of the railroads in the Northeast and Midwest regions of the country. Although at all times a solvent corporation, the D&BB was nonetheless affected by the 1973 Rail Act because it had leased all of its rail properties to the Reading Company and that corporation had filed a petition for reorganization under Section 77 of the Bankruptcy Act (A.120). *In re Reading Company,* Bankruptcy No. 71-828, E.D. Pa. Because the D&BB was a railroad "operated, leased or controlled by a railroad in reorganization" (*i.e.,* the Reading Company), the D&BB was subject to the provisions of the 1973 Rail Act even though the D&BB had itself never filed for reorganization.

As a railroad subject to the 1973 Rail Act, the D&BB was required by such statute to transfer the entirety of its rail properties to the Consolidated Rail Corporation

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1 References to "(A. —)" are to the Appendix on file with the United States Court of Appeals for the Third Circuit. References to "(App. —)" are to the Appendix attached to this Petition.

2 Pub. L. No. 93-236, 87 Stat. 985 (1974) (current version at 45 U.S.C. § 701 *et seq.* (Supp. 1985)). This Act is hereinafter cited as the "1973 Rail Act".

("ConRail") as part of the reorganization of railroads in the Northeast and the Midwest. 45 U.S.C. §§ 716(d); 743(b); (A.95-97, A.120). ConRail was a private, for profit corporation. 45 U.S.C. § 741.

In exchange for rail properties transferred to ConRail, the 1973 Rail Act provided that "*[a]ll rail properties . . . shall be transferred in exchange for stock and other securities*" of ConRail and the United States Railway Association ("USRA"). 45 U.S.C. § 716(d)(1) (emphasis added). It was Congress' intent that, as a result of such exchange, the transferors would acquire an equity interest in ConRail. *See Blanchette v. Connecticut General Insurance Corporations,* 419 U.S. 102, 130-131 (1974)[3] *relying on* 119 Cong. Rec. S. 23783-23784 (December 21, 1973) (remarks of Sen. Hartke) H. R. Rep. No. 93-620, p.55 (1973); 119 Cong. Rec. H. 9741 (November 8, 1973) (remarks of Rep. Metcalfe); *Id.* at H. 9746 (remarks of Rep. Conte). That equity interest consisted of the right to receive an unspecified amount of ConRail stock at some unspecified future date. *Blanchette,* 419 U.S. at 154-156.

Under the statutory scheme, ConRail securities and USRA obligations would not be immediately transferred to the transferor railroads. Instead, such instruments were to be deposited with the Special Court (45 U.S.C. § 743(a), A.121) pending that court's determination as to whether the statutorily-mandated exchanges were "fair and equitable" to the transferor railroads and whether the securities package given to the transferors had a value

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[3] Because the *Blanchette* case is frequently quoted throughout this Petition, it will hereinafter be simply referred to as *Blanchette*.

that satisfied "constitutional minimum" requirements. 45 U.S.C. § 716(d)(1); *see* 45 U.S.C. §§ 720, 743(c); *Blanchette,* 419 U.S. at 148, 154.

Because the transferors were concerned both that there would be a long delay before they received compensation and that their compensation would be paid "not in cash but largely in stock of an unproved entity" (*Blanchette,* 419 U.S. at 137), the constitutionality of the 1973 Rail Act was attacked as a Fifth Amendment taking of property without due process or adequate compensation.

In *Blanchette,* this Court rejected the transferors' challenge and specifically held that the 1973 Rail Act was constitutional *as a reorganization statute,* rather than a condemnation statute. 419 U.S. at 150. This Court also held that a Court of Claims remedy under the Tucker Act was available to the railroad transferors in the event that ConRail stock ultimately had insufficient value to compensate them for their rail properties.

Although upholding the 1973 Rail Act's constitutionality, this Court acknowledged that the controversy over the proper valuation theories to be applied to both the transferred rail properties and the ConRail stock made the 1973 Rail Act unique and burdensome to transferors. *Blanchette,* 419 U.S. at 146. As this Court specifically stated:

> Until [the Final System] Plan has been fully developed, the courts will not have any . . . settled facts concerning the rail properties to be conveyed, the valuation of those properties, or the value of Conrail stock and other securities to be transferred . . .
>
> . . . Further . . . the conveyance, because of its complexity and because of the long time lapse probable

> before valuation review is completed, in practical effect will be irreversible once it is made.
>
> * * *
>
> This Act does differ from other reorganization statutes . . . in that it *requires* a conveyance before it is possible to ascertain [whether the proposed securities package was a fair medium of compensation for the exchange]. Thus, the conveyance is mandated without any prior judicial finding that there will be adequate resources in the reorganized company of whatever kind to compensate the debtor estates and, eventually, their creditors. 419 U.S. at 145, 155 (emphasis in original).

In response to *Blanchette,* Congress enacted the Railroad Revitalization and Regulatory Reform Act.[4] The 1976 Rail Act modified the provisions of the 1973 Rail Act in order to avoid the Tucker Act remedy recognized by *Blanchette.* Under the 1976 Rail Act, railroad transferors were still to receive ConRail securities except that each share of ConRail preferred stock was to be accompanied by a newly created instrument: a Certificate of Value ("CV") which was to be issued by USRA. *See In the Matter of the Valuation Proceedings Under §§ 303(c) and 306 of the Regional Rail Reorganization Act,* 425 F. Supp. 266, 276 (Special Court 1976).

By statute, the CVs were to be redeemed by USRA on a date specified by it, but not later than December 31, 1987. 45 U.S.C. § 746(c); *see In the Matter of the Valua-*

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[4] Pub. L. No. 94-210, 90 Stat. 31 (1976) (current version at 45 U.S.C. § 701 *et seq.* (Supp. 1985)). This Act is hereinafter cited as the "1976 Rail Act". The 1973 Rail Act and the 1976 Rail Act are collectively referred to as the "Rail Acts."

*tion Proceedings Under §§ 303(c) and 306 of the Regional Rail Reorganization Act,* 425 F.Supp. at 276. The purpose of the CVs was to assure that, *on their statutory redemption date* (45 U.S.C. § 746(c)(2); S. Rep. No. 499, 94th Cong., 2d Sess. 91-92, *reprinted in* 1976 U.S. Code Cong. & Ad. News 106-107), the cash value of the ConRail securities package received by each transferor railroad would constitute the "fair and equitable equivalent" (*Blanchette,* 419 U.S. at 154) of the rail properties conveyed to ConRail. In short, the purpose of the CVs was to cover any constitutional shortfall between the value of the rail properties given by the transferor railroads and the value of what they actually received on the statutorily-deemed consummation date of the exchange.

Except for Congress' addition of CVs to the overall securities package in order to avoid possible constitutional infirmities, the 1976 Rail Act did nothing to alter Congress' intent that ConRail stock would in fact be given to the transferor railroads in exchange for their rail properties and that such stock would serve as the principal, if not sole, consideration for the exchange.

Under the statutory framework, the holders of CVs were entitled to receive the CVs' redemption value. That value was to be determined as a function of the CVs' "Base Value". Pursuant to 45 U.S.C. § 746(c)(4), "Base Value" was statutorily defined as the sum which results from making the following calculations:

(a) take the net liquidation value of a transferor's properties as determined by the Special Court;

(b) subtract the "value of other benefits" provided to a transferor under the Rail Acts;

(c) add any amount needed to compensate for "unconstitutional erosion" suffered by a transferor as the result of the Rail Acts;

(d) add 8% interest from April 1, 1976 to the date on which the CVs were redeemed, at the rate of 8% per annum, compounded annually.[5] *See In the Matter of the Valuation Proceedings Under §§ 303(c) and 306 of the Rail Reorganization Act,* 425 F.Supp. at 276-77.

The determination of "Base Value" is important because it is used to calculate the CVs' redemption value. Redemption value equalled CVs' "Base Value" on their redemption date reduced by

(a) the market, or appraised, value of the accompanying ConRail securities (such value to be determined on the same date as the CVs' redemption date); *and*

(b) the amount of any dividends previously declared on the ConRail securities; *and*

(c) any payments made by ConRail to the transferor for assets sold or leased. 45 U.S.C. § 746(c)(2).

As can be seen from the above, "Base Value" did not necessarily equal the CVs' redemption price. Depending upon the value of ConRail stock and other compensation paid to the transferors, it was conceivable that the CVs could have no redemption value at all. S. Rep. No. 499, 94th Cong., 2d. Sess. 91, *reprinted in* 1976 U. S. Code Cong. & Ad. News 106. Such a result would have been entirely in keeping with the congressional intent that Con-

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[5] It is the tax impact, if any, of the 8% interest component of "Base Value" which is the issue presented in this Petition.

Rail stock would, and should, alone be adequate consideration for the transferred rail properties. As also indicated above, the CVs were to play a role in the valuation process only if ConRail stock had insufficient market value on the CVs' redemption date to compensate railroad transferors for the exchange. In that context, the CVs were "adjusters" as described by the Third Circuit. (App. 8). This role was entirely in keeping with the CVs' function as a substitute for a Tucker Act remedy.

The transfer of the D&BB's rail properties to ConRail in return for the right to receive an unquantified amount of ConRail securities and CVs at some unspecified future date occurred by operation of law on April 1, 1976. 45 U.S.C. § 743(b). Although ConRail was required eventually to transfer to the D&BB ConRail securities and CVs, such instruments were *not* immediately transferred to the D&BB. (A.9, A.121). Instead, such ConRail securities and CVs were deposited with the Special Court, as statutorily required, until such time as the Special Court could determine the net liquidation value of the D&BB's rail properties. 45 U.S.C. § 743(a) and (c); 45 U.S.C. § 746 (a); (A.9-10, A.121).

On August 13, 1981, the Omnibus Budget Reconciliation Act of 1981 eliminated ConRail securities as property which could be given by USRA in exchange for rail properties and determined that the ConRail securities had no fair market value for purposes of computing the amount for which CVs were redeemable. 45 U.S.C. § 1115.

On August 25, 1981 the D&BB and USRA entered into a contingent settlement agreement (the "D&BB/USRA Settlement Agreement") which resolved the

D&BB's disputes which were pending before the Special Court.[6] (A.10-11, A.122).

The D&BB/USRA Settlement Agreement was conditioned on the settlement's becoming an integral part of a plan of complete liquidation of the D&BB. (A.11, A.122-123). On September 24, 1981, the D&BB's stockholders adopted such a plan of complete liquidation pursuant to Section 337 of the Internal Revenue Code. (A.11, A.123).

On November 13, 1981 and in compliance with the formula set forth in 45 U.S.C. § 743(c)(4), the D&BB received CVs worth $6,802,660. (A.123). No cash or other property was given to the D&BB along with such CVs. (A.11). After the final execution of settlement papers and after the D&BB's receipt of its CVs, USRA redeemed the D&BB's CVs for cash. (A.11, A.123).

In accordance with the § 337 plan of complete liquidation approved by the D&BB's shareholders on September 24, 1981, the assets of the D&BB were liquidated and distributed to its stockholders except for a reasonable amount which was transferred to a liquidation trust, with the Petitioners as escrow agents, for payment of contingent obligations.

The D&BB subsequently sought two separate private letter rulings from the Internal Revenue Service concerning the interest component of the CVs. It was and remains the D&BB's contention that the CVs' interest component

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[6] The D&BB notes that in its settlement agreement with the USRA, it clearly reserved all of its claims on tax issues, including those presented in this Petition. (A. 46). As a result, no estoppel lies by virtue of the D&BB's execution of the D&BB/USRA Settlement Agreement.

was an integral part of "Base Value" and, as such, was a return on capital. As a result, the D&BB claimed that CV interest should be taxed as a capital gain. The Internal Revenue Service disagreed and ruled in both private letter rulings that the interest component of the CVs did not constitute proceeds from the sale or exchange of a capital asset but was ordinary income taxable to the D&BB even though received during the course of its § 337 liquidation.

In compliance with the letter rulings, the D&BB reported the interest component of the CVs as ordinary income and paid the resulting tax thereon. The D&BB subsequently filed an amended return seeking a refund of the taxes paid. Upon denial of the refund claim, the suit below was started.

The district court granted summary judgment for the D&BB. The district court ruled that CV interest was

> a component of the base value of the certificates of value . . . . The interest component is thus an integral part of the redemption, or base, value for rail properties, and is not an amount in excess of the value of such properties. (App. 39).

The Third Circuit reversed and held that CV interest represented "payment for the detention of money" and, as compensation for delay, CV interest should be considered taxable as ordinary income *even though paid in furtherance of a reorganization.*

The D&BB contends that, in light of this Court's opinion in *Blanchette,* the district court was correct and that the Third Circuit was wrong in its characterization of the nature of CV interest. The D&BB notes, however, that

even if the Third Circuit's characterization is correct, the Third Circuit's ruling is the only case (of which counsel is aware) which holds that compensation for delay in effecting a reorganization is taxable as ordinary income. The Third Circuit has established a rule which no other circuit has recognized and, in fact, such rule is contrary to the Second Circuit's decision in *Commissioner of Internal Revenue v. Carman*, 189 F.2d 363 (2d Cir. 1951).

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## REASONS FOR GRANTING THE WRIT

### SUMMARY OF ARGUMENT

Petitioners believe that the opinion of the Third Circuit is in direct conflict with this Court's opinion in *Blanchette*. This is evident in several areas.

First, the Third Circuit treats the interest component of CVs in the same manner as payment for the detention of money in a sales transaction or condemnation proceeding. The Third Circuit's treatment of CV interest is inconsistent with this Court's holding that transfers under the Rail Acts are exchanges. As a component of the statutory compensation received from a valuation proceeding under the Rail Acts, CV interest must be treated as an integral part of such exchange and as payment received in furtherance of a reorganization. Such a result seems mandated by *Blanchette*.

The significance of the Third Circuit's refusal to abide by *Blanchette* is critical because the Third Circuit's characterization of CV interest as payment for the deten-

tion of money results in CV interest being treated as ordinary income. Had the Third Circuit characterized CV interest as compensation received as an integral part of the ConRail exchange, such compensation would have been treated as capital gain.

Second, the Third Circuit refuses to recognize that the D&BB had a right to receive ConRail stock. This right was specifically recognized both by the 1973 Rail Act and by *Blanchette*. The significance of this error is critical because the Third Circuit has implicitly stated that had the D&BB had a right to receive ConRail stock, the Third Circuit would have affirmed the district court's opinion rather than reverse it. (App. 17-18, n.5).

Because the Third Circuit's opinion is directly inconsistent with this Court's opinion in *Blanchette, certiorari* should be granted. Where appellate decisions in the area of taxation conflict with decisions of this Court, this Court has granted *certiorari*. *Parsons v. Smith*, 359 U.S. 215 (1959).

Petitioners further believe that the opinon of the Third Circuit conflicts with the decision of the Second Circuit in *Commissioner of Internal Revenue v. Carman*, 189 F.2d 363 (2d Cir. 1951). The *Carman* case holds that compensation for delay in consummating a reorganization is to be treated, for tax purposes, by the nature of the underlying asset for which compensation is paid. The Third Circuit, on the other hand, has held that all compensation for delay in consummating a reorganization is compensation for the detention of money and, as a result, is to be treated as ordinary income. By refusing to follow the Second Circuit's *Carman* decision, the Third

Circuit has created a split among the circuit courts. For this reason, the Petitioners' request for *certiorari* should be granted.

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## ARGUMENT

### POINT I

### THE INTEREST COMPONENT OF CVs WAS AN INTEGRAL PART OF THEIR "BASE VALUE" AND WAS PAID AS PART OF AN EXCHANGE AND IN FURTHERANCE OF A PLAN OF REORGANIZATION. AS SUCH, CV INTEREST SHOULD BE AFFORDED CAPITAL GAIN TREATMENT.

The transaction between the D&BB and ConRail is to be contrasted with a sale or a condemnation proceeding. The D&BB's transfer of its rail properties was neither a sale nor a transfer arising out of a condemnation. The D&BB was not liquidating its ownership interest in rail properties.

Instead, the transfer by the D&BB of its assets to ConRail was an *exchange* in furtherance of a plan of reorganization. In *exchange* for its ownership interest in rail properties, the D&BB expected to receive an ownership (equity) interest in ConRail in the form of a package of securities consisting of ConRail stock and Certificates of Value.

The tax impacts of a sale versus an exchange are significant.

In a sale transaction and in a condemnation, the disposing property owner *liquidates* his ownership interest

in property. Unless the installment sale provisions of the Internal Revenue Code apply, the sale will invariably result in an immediate tax incident, *i.e.*, immediate gain or loss. On the other hand, an exchange involves a *substitution* of new property for old property, not a liquidation. As a result, the property owner continues his ownership interest in property without interruption. Under certain exchanges, particularly those involving corporate reorganizations, the transferor's interest in the old property is even deemed to be continued indirectly through ownership of the new property. As a consequence of such continuity of interest, the tax incident is deferred until disposition of the new property, and the transferor's tax basis in the old property is continued in the new property. *See* 26 U.S.C. §§ 354 and 358.

*Blanchette* discussed the distinction between a reorganization and a condemnation/sale. After such discussion, *Blanchette* specifically held that the 1973 Rail Act was a reorganization "exchange" statute rather than a condemnation statute. *Blanchette,* 419 U.S. at 148, 150. *Blanchette* also recognized that the railroad transferors would receive as compensation for the exchange a "fair and equitable" securities package equal to the constitutional minimum value of their properties. *Blanchette,* 419 U.S. at 147-49, 154.

Despite this, the Third Circuit refused to view the Rail Acts' compensation package as a single indivisible unit which was to be paid in furtherance of a plan of reorganization. Instead, the Third Circuit divided the value of the compensation package (*i.e.*, "Base Value") into its various parts and singled out the CV interest component of "Base Value" for separate treatment. This

was an action not even remotely sanctioned by the Rail Acts or by *Blanchette.*

Indeed, if anything, the opposite is true. In the legislative history of the 1976 Rail Act, Congress was deliberate enough to provide that the transfer of rail properties should be treated as an exchange for tax purposes *even if equities were not received by the transferor railroads and traditional continuity of interest tests were not met.* H. Rep. No. 940, 94th Cong., 2d Sess. 6, *reprinted in* 1976 U.S. Code Cong. & Ad. News (94th Cong., 2d Sess.) 479-480. This provides strong evidence that *all* components of the compensation package given to the transferor railroads (including CV interest which was created by the 1976 Rail Act) were an inherent part of the exchange transaction and were to be treated as integral parts of an indivisible unit. If the transferor railroads' compensation package is an indivisible unit, any growth in the value of that unit is eligible for capital gain treatment when such growth is realized upon the sale or other disposition of the compensation package. 26 U.S.C §§ 1221 and 1222. Such disposition would include USRA's redemption of the D&BB's CVs.

The true nature of CV interest is precisely as was held in the district court opinion in this action:

> The provisions of 45 U.S.C. Section 746(c)(4) include the 8% annual interest as a component of the base value of the certificates of value, and do not add the interest once the base value has been determined. The interest component is thus an integral part of the redemption, or base, value for rail properties, and is not an amount in excess of the value of such properties. (App. 39).

The district court's opinion is consistent with *Blanchette*. The Third Circuit's opinion is not.

The Third Circuit applies the holding of *Kieselbach v. Commissioner*, 317 U.S. 399 (1943) (a condemnation case) to the ConRail valuation proceeding (a reorganization case). By its action, the Third Circuit ignores the fact that the D&BB's compensation was given in an exchange and paid in furtherance of a reorganization. In effect, the Third Circuit treats as a condemnation or forced sale the basic reorganization "exchange transaction" between ConRail and the transferor railroads and summarily converts the D&BB from being an equity holder to being a creditor. This violates *Blanchette's* instruction that transactions under the Rail Acts are exchanges rather than condemnations. This also violates the Rail Acts' mandate that transferor railroads are to be treated as equity holders even if continuity of interest tests are not met.

Based on the rationale of *Blanchette* and the intent of the Rail Acts, the transactions under the Rail Acts should be treated as exchanges for all purposes, including taxation.

## POINT II

## THE THIRD CIRCUIT IGNORED BLANCHETTE'S RECOGNITION OF THE TRANSFEROR RAILROADS' RIGHT TO RECEIVE CONRAIL STOCK.

The Third Circuit has also erred in stating that railroad transferors such as the D&BB had only on expectation rather than a right to receive ConRail stock. While

this error appears throughout the Third Circuit's opinion and colors it accordingly, the error of the Third Circuit is most clearly set forth in its following statement:

> D&BB effectively asks to be treated as if it held common and preferred ConRail stock, or had a right to hold such stock, until August 13, 1981, and then was forced to exchange its stock for CVs. However, D&BB did not hold anything before the Omnibus Reconciliation Act; it had only a claim to a certain amount of compensation in whatever form Congress saw fit to provide. Admittedly, until August 31, 1981, D&BB may have *expected* that it would receive equity instead of ordinary income, but it had no *right* to such payment. (App. 27) (emphasis in original).

The Third Citrcuit's statement is directly contradicted by the 1973 Rail Act, by the 1976 Rail Act, by the legislative history of those statutes and by *Blanchette*. An analysis of each of these authorities clearly shows that the D&BB's stockholders not only had a statutory *right* to receive ConRail stock but were statutorily forced to accept such stock as part of the ConRail exchange so as to become equity holders of ConRail.[7]

The 1973 Rail Act specifically provided that "All rail properties to be transferred to [ConRail] *shall* be transferred in exchange for stock." 45 U.S.C. § 715(d)(1) (emphasis added). In the legislative history of the 1973 Rail Act, Congress made clear its intent that there would be an exchange of equities and that the transferors of

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[7] This was especially so in the case of the D&BB which had no bondholders or other creditors. As a result, its stockholders expected to transfer their stock ownership interests in the D&BB to become stockholders of ConRail, a simple equity for equity swap or exchange.

rail property to ConRail would receive stockholder/equity positions in ConRail. This Court specifically recognized such intent in *Blanchette.* 419 U.S. at 131, *relying on* 119 Cong. Rec. S. 23783-23784 (December 21, 1973) (remarks of Sen. Hartke); 119 Cong. Rec. H. 9741 (November 8, 1973) (remarks of Rep. Metcalfe); *id.* at H. 9746 (remarks of Rep. Conte). Indeed, in examining 45 U.S.C. § 715(d)(1), this Court specifically found that, pursuant to congressional directive, USRA "*must* provide for transfer of designated rail properties . . . in return for securities of Conrail." *Blanchette,* 419 U.S. at 111 (emphasis added).

The 1976 Rail Act more fully defined the railroad transferors' rights as stockholders by authorizing the appointment of voting trustees who were to exercise the rights of the transferor railroads as "holders" of the stock. Under the statutory framework, these directors would be appointed by the Special Court on behalf of the railroad transferors:

> For and during the period between the deposit of securities of [ConRail] with the special court in accordance with [45 U.S.C.] Section 743(a) of this title, and the distribution of such securities, in accordance with [45 U.S.C.] Section 743(c) of this title, the special court shall . . . appoint one or more voting trustees for each class of securities which is so deposited. *Such voting trustees shall, on behalf of the distributees exercise the rights of the holders of such securities as their interests may appear.* Within 30 days after such appointment, such voting trustees shall select members of the Board of Directors of [ConRail] on behalf of the holders of the class of securities whose rights they exercise pursuant to this subsection. 45 U.S.C. § 741(g) (emphasis added).

The legislative history of the 1976 amendments details the composition of the ConRail Board of Directors. As the history sets forth:

> The ConRail Board will have 13 members, consisting of six individuals representing the debentures and Series A Preferred Stock, three selected by the Series B Preferred stockholders, and two by the Common stockholders (*the last two classes being initially the transferors of properties to ConRail*). S. Rep. No. 499, 94th Cong., 2d Sess. 93, *reprinted in* 1976 U.S. Code Cong. & Ad. News 102 (emphasis added).

Thus, the legislative history of both the 1973 Rail Act and the 1976 Rail Act makes clear that the transferor railroads had a proprietary interest in ConRail stock sufficient to justify the transferors having representation on ConRail's Board of Directors.

The D&BB's right to receive ConRail stock existed at all times up to the enactment of the Omnibus Budget Reconciliation Act of 1981. The passage of that statute did not and could not change the pre-existing facts, however. If anything, that Act corroborates them. Pursuant to the Omnibus Budget Reconciliation Act of 1981, all of the ConRail stock held by the Special Court was *reconveyed* by the clerk of the Special Court to the Secretary of Transportation. The requirement of "reconveyance" underscores the fact that the affected ConRail stock had at the very least been beneficially conveyed to the transferors as of April 1, 1976.

All of these factors point to the very real proprietary interest of the D&BB in ConRail stock. There is no indication in the Third Circuit's opinion which explains why

it believed that the transferors had merely an "expectation" to ConRail stock rather than a right to it. Indeed, if the railroad transferors were not the beneficial owners of the ConRail stock between April 1, 1976 and the enactment of the Omnibus Budget Reconciliation Act of 1981, it is unclear who was. The Third Circuit's conclusion (stated with no legal citation or support whatsoever) that the D&BB had "only a claim to a certain amount of compensation in whatever form Congress saw fit to provide" (App. 27) flies in the face of the 1973 Rail Act, its amendments and *Blanchette's* interpretation thereof.

The significance of the Third Circuit's error is critical because the Third Circuit has implicitly conceded that had the D&BB received ConRail stock—or had the D&BB had at least a right to receive such stock—the result it reached would have been different. As the Third Circuit expressly stated:

> Granted, from D&BB's perspective it is *unfortunate* that D&BB is burdened by heavier tax consequences of account of being paid in CVs rather than Conrail stock, but because D&BB never had a right to payment in Conrail stock . . ., we find nothing unfair about this circumstance. (App. 18, n.5 cont'd) (emphasis in original).

*Blanchette* clearly establishes the D&BB's right to ConRail stock. The Third Circuit's failure to follow *Blanchette* has resulted in a decision adverse to the D&BB.

## POINT III

### BLANCHETTE CREATED AN EXPECTATION THAT RAILROAD TRANSFERORS WOULD RECEIVE CONRAIL STOCK. THE THIRD CIRCUIT ERRED BY HOLDING THAT THE D&BB COULD NOT RELY ON THAT EXPECTATION.

The Third Circuit erred when it concluded that the transferor railroads could not have relied on any expected equity payment of ConRail stock because the transfer of the D&BB's rail properties was forcible. (App. 27). In effect, the Third Circuit reasoned that because the D&BB's April 1, 1976 conveyance of its rail properties to ConRail was not negotiated but involved an involuntary transfer, the D&BB could not bargain for the form of consideration it would receive. Although the D&BB did not bargain for the consideration set forth in the Rail Acts, the Third Circuit's conclusion does not address the true "reliance" issue and is in error for several reasons:

First, it was specifically recognized in *Blanchette* that the transfer of rail properties would be separated by a "long time lapse" (419 U.S. at 145) before the transferor railroads would receive return consideration. Indeed, the transferors' general concern that the value of ConRail stock after such delay was unknown and would be inadequate precipitated the *Blanchette* litigation. 419 U.S. at 137-138. In this context, it is significant that *Blanchette* established the constitutionality of the 1973 Rail Act based upon the right of the transferors to receive ConRail stock, *the compensation statutorily formulated.*

Based on the holding of *Blanchette*, it appears clear that the D&BB and the other transferor railroads had both a legal and an equitable right to rely on receiving the consideration prescribed by the 1973 Rail Act. This is especially so when *Blanchette* upheld the constitutionality of that prescribed consideration. In the light of the very specific language of the 1973 Rail Act and *Blanchette's* ruling thereon, it was error for the Third Circuit to have concluded that the transferors could not have relied on the compensation specifically and statutorily provided for them. The Third Circuit's ruling in this regard rewrites the Rail Acts and puts itself in direct conflict with *Blanchette*.

Secondly, the D&BB relied to its detriment on the 1973 Rail Act's mandate that it would be given ConRail stock. It is clear that the D&BB could have undergone a § 337 liquidation during the pendency of the ConRail valuation proceeding. Had it done so at any time *prior* to the enactment of the Omnibus Reconciliation Act of 1981, the D&BB could have distributed to its shareholders pro-rata rights in the valuation litigation as part of such a § 337 liquidation. In this regard, the legislative history of 26 U.S.C. § 374 expressly contemplated that *shareholders* of railroad transferors had the right to hold ConRail stock and CVs.[8] Moreover, as the legislative history excerpted

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[8] The legislative history of 26 U.S.C. § 374 notes that

> . . . no gain or loss is to be recognized by *any shareholder* or creditor of a transferor who surrenders stock or a debt instrument . . . in the transferor and receive[s] in exchange ConRail stock and USRA certificates of value. H. Rep. No. 940, 94th Cong., 2d Sess. 8,

(Continued on following page)

in the footnote below shows, stockholders of a transferor could hold CVs only and still enjoy nonrecognition treatment.

In light of this, it seems clear that had the D&BB liquidated at any time prior to redemption of the CVs, the D&BB would not have been involved in the redemption transaction which the Third Circuit deems so crucial. Such liquidation would also have prevented the double taxation which the D&BB seeks to avoid.

Based on the above discussion, it was error for the Third Circuit to conclude that the D&BB could not have relied on receiving ConRail stock because its exchange of assets was forcible. Reliance in the case at bar has absolutely nothing to do with the forced transfer of assets. Instead, reliance in the case at bar turns on the D&BB's continued expectation (1) that its compensation rights were statutorily defined by the 1973 Rail Act and were judicially construed by *Blanchette* to require the payment

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(Continued from previous page)

*reprinted in* 1976 U.S. Code Cong. & Ad. News 482 (emphasis added).

Footnote 11 to this statement goes on to say that:

Under present law, shareholders or security holders in a bankrupt railroad are not subject to the excess principal rule of sec. 344(a)(2); the bill follows the same treatment in the Conrail reorganization. Thus, *if a shareholder of a transferor receives ConRail debt securities (as possibly could be ordered by the special court), he will also receive nonrecognition treatment.* H. Rep. No. 940, 94th Cong., 2d Sess. 8, *reprinted in* 1976 U.S. Code Cong. & Ad. News 482 (emphasis added).

of ConRail stock and (2) that, as a result, it made no difference whether the D&BB liquidated its assets prior to the resolution of the ConRail valuation proceeding or, as it in fact did, as part of a § 337 dissolution which was an integral part of that litigation's resolution. (App. 9-11; A. 11).

The Third Circuit's error in failing to follow the instruction of *Blanchette* is critical. Indeed, as set forth above, the Third Circuit has indicated that it would have reached a different result had it believed that the D&BB was entitled to or had a right to ConRail stock. (App. 17-18, n.5).

## POINT IV

## THE THIRD CIRCUIT IMPROPERLY ANALYZED THE EFFECT OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1981.

The Third Circuit fundamentally erred in analyzing the effect of the Omnibus Budget Reconciliation Act of 1981. The Third Circuit concluded that such Act had no effect on the D&BB. As the Third Circuit stated:

> [O]n August 13, 1981 [the date of the enactment of the Omnibus Budget Reconciliation Act of 1981], ConRail equity was virtually worthless. This means that even had the law not changed on August 13, 1981, ConRail [sic] would have received all CVs anyway. It is thus inaccurate to say that D&BB swapped equity for debt on August 13, 1981. The change in law simply

> ratified something that would at all events have happened. (App. 27).

This statement is not true.

As the Third Circuit found, the CVs were intended by Congress to be simply "adjusters". (App. 8). As "adjusters", their role, if any, would come into play only on their redemption date. In the absence of the D&BB/USRA Settlement Agreement, that date could have been any date chosen by USRA up to December 31, 1987 (more than 6 years after the date of the D&BB/USRA Settlement Agreement).

It is thus obvious that in the absence of the Omnibus Budget Reconciliation Act of 1981, ConRail stock would have been distributed under the Rail Acts *even if such ConRail stock had no value on the D&BB/USRA settlement date.* It was the value of ConRail stock on the CVs' redemption date rather than such stock's value on either August 13, 1981 or the D&BB/USRA settlement date which was critical. In no event could the value of ConRail stock on either date affect the D&BB's right to such stock.

For this reason, the change in law effected by the Omnibus Reconciliation Act of 1981 did not simply ratify something that would in all events have happened, as the Third Circuit held. Indeed, recent events concerning the possible sale of ConRail (events which are occurring well before the CVs' December 31, 1987 statutory redemption date) confirm that ConRail stock was and is not "virtually worthless" as stated by the Third Circuit.

The Third Circuit's error was critical to the D&BB's position. During the period from April 1, 1976 (the conveyance date) to August 13, 1981 (the date of the Omni-

bus Budget Reconciliation Act of 1981), D&BB was not a creditor entitled to the repayment of a debt. Instead, the D&BB was an equity holder temporarily deprived of control over its property because of the unique nature of the Northeast rail organization. *Blanchette,* 419 U.S. at 145-146, 155-156. By holding that the Omnibus Budget Reconciliation Act of 1981 ratified something that in all effects would have happened, the Third Circuit changed the D&BB from an equity holder into a debtor and did so as of April 1, 1976. This is in direct conflict with the 1973 Rail Act and *Blanchette's* holding that railroad transferors were entitled to receive and would, in fact, receive equity positions in ConRail.

## POINT V

### THE THIRD CIRCUIT'S DECISION CONFLICTS WITH THE SECOND CIRCUIT'S DECISION IN COMMISSIONER OF INTERNAL REVENUE v. CARMAN, 189 F.2d 365. THIS COURT SHOULD RESOLVE CONFLICTS AMONG THE CIRCUITS.

Because CVs were created in response to *Blanchette,* it is the contention of the D&BB that CVs must be viewed in light of *Blanchette.* As such, it is clear that CVs, and, as a result, CV interest, were designed only to cover shortfalls between the value of ConRail stock and the constitutional minimum value of rail properties, as determined by the Special Court.

Notwithstanding the foregoing, even if it is assumed that the Third Circuit's characterization of CV interest as compensation for delay is correct (which the D&BB disputes), this case is the first case (of which counsel is aware) which holds that compensation paid for a delay in

consummating a reorganization proceeding is taxable as ordinary income.

One other circuit, the Second Circuit, in *Commissioner of Internal Revenue v. Carman,* 189 F.2d 363 (2d Cir. 1951), ruled that compensation paid for delay in consummating a reorganization proceeding is "in pursuance of the plan of reorganization". 189 F.2d at 365, *citing* 26 U.S.C. § 112(b)(3), the predecessor of 26 U.S.C. § 354. As such, it is to be afforded capital gains treatment. *Cf. Prizant v. Commissioner,* 30 T.C.M. 817 (1971) (compensation for the forbearance of control over property is deemed to be of a capital nature).

The *Carman* court reasoned that the consummation date of the exchange determines whether gain or loss should be recognized on the assets surrendered. The Second Circuit held that an exchange is not consummated until the date on which the return consideration is received. Consequently, *adjustment payments* are money ("boot") received in the exchange. *Grey v. U.S.,* 48 AFTR 133 (D. Utah 1953), 54-1 USTC 9318, involves facts similar to *Carman* and follows *Carman's* holding. *See also Estate of William Bernstein,* 23 T.C. 1364 (1954).

The Third Circuit did not follow the *Carman* holding. In so doing, the Third Circuit has established a new rule for the Third Circuit. To the extent that the Third Circuit's decision is inconsistent with the Second Circuit's *Carman* decision, a conflict has been created among the circuits. For this reason, the Petitioners' request for *certiorari* should be granted.

## CONCLUSION

The issue raised in this Petition presents one of the last controversies arising out of the Rail Acts—*i.e.*, the tax treatment of the compensation paid to the transferor railroads. Just as this Court ruled on the statutes giving birth to the various ConRail proceedings, it is only fitting that this Court should now rule on a concluding issue which emanates from those statutes. This is especially so here, where the issue presented will have an impact on the various transferor railroads which share a position similar to the D&BB.

For all of the foregoing reasons, the Petitioners respectfully request that this Court grant *certiorari.*

Respectfully submitted,

MEYNER AND LANDIS
*Attorneys for the Petitioners*

JOHN N. MALYSKA

Dated: January 2, 1987

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

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NO. 85-5432

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RICHARD DRAYTON,
JOHN R. SAUERTEIG, and SYDNEY G. STEVENS,
as escrow agents of THE DELAWARE & BOUND
BROOK RAILROAD COMPANY,

*Appellees*

v.

UNITED STATES OF AMERICA,

*Appellant*

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On Appeal from the United States
District Court for the
District of New Jersey
(D.C. Civ. No. 84-3418)

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Argued April 14, 1986

Before: SEITZ, HIGGINBOTHAM, BECKER,
*Circuit Judges*

(Filed September 11, 1986)

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OPINION OF THE COURT

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BECKER, *Circuit Judge.*

This income tax case arises in the aftermath of the Rail Reorganization Act. Before us on an appeal from the judgment of the district court in a tax refund suit, it requires us to determine the proper income tax treatment of the interest component of certificates of value delivered to the shareholders of the transferor railroads as compensation for their properties. The district court ruled that the interest component was non-taxable pursuant to 26 U.S.C. § 374(c) (1982). We disagree, however, and hold that the income is fully taxable as ordinary

income. Hence, we shall reverse the district court's grant of summary judgment and instruct the court to enter a summary judgment for the government.

## I. THE STATUTORY FRAMEWORK

### A. *The Rail Act through* Blanchette -

By the late 1960's and early 1970's eight railroads in the northeast and midwest sections of the country had fallen on hard times. Experiencing both physical and financial deterioration, they filed petitions for bankruptcy and began to undergo reorganizations in the bankruptcy courts. However, Congress superseded the reorganization process when it passed the Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1974), 45 U.S.C. § 701 *et seq.* (the Rail Act) (*amended* 1976, 1981) a comprehensive effort to save the nation's railway system through a combination of public agencies and private initiative.

The Rail Act established a government corporation, the United States Railway Association (USRA), 45 U.S.C. § 711(a) (1982), which was to develop a Final System Plan for restructuring the railroads into a "financially self-sustaining rail service system." 45 U.S.C. § 716(a)(1) (1982). The Final System Plan was to provide for the transfer of certain of the properties of the bankrupt railroads to a private railroad incorporated by the federal government, the Consolidated Rail Corporation (Conrail). Pub. L. 93-236, Title III § 301, 87 Stat. 1004 (1974), *codified at* 45 U.S.C. § 741 (1982). In exchange, the railroads whose properties were taken were to receive common and preferred Conrail stock, plus up to $500 million of USRA obligations guaranteed by the United States. Pub. L. 93-

236. Title II, § 206(d)(1), 87 Stat. 994 (1974), *codified at* 45 U.S.C. § 716(d)(1) (1982); *see also* Pub. L. No. 93-236, Title II § 210, 87 Stat. 1000 (1974), *codified at* 45 U.S.C. § 720 (1982) (*amended* 1980).

In July, 1975, the USRA duly submitted its Final System Plan to Congress, which acquiesced to the plan by not disapproving it within sixty days of its submission. Pub. L. No. 93-236, Title II, § 208, 87 Stat. 999 (1974 *codified at* 45 U.S.C. § 718 (1982). USRA then submitted all of the Conrail securities and the requisite number of USRA obligations to a Special Court created by the Rail Act, Pub. L. No. 93-236, Title II, § 209, 87 Stat. 999 (1974), *codified at* 45 U.S.C. § 719(b) (1982).

The Special Court was assigned two primary tasks. First, it was to "order the trustee or trustees of each railroad in reorganization . . . to convey forthwith [to Conrail] . . . all right title and interest in the rail properties of such railroad in reorganization [as designated in the Final System Plan]," Pub. L. 93-236, Title III, § 303, 87 Stat. 1005 (1974), *codified at* 45 U.S.C. § 743(b) (1982). Second, railroads whose assets were transferred to Conrail and which were dissatisfied with the compensation allotted to them by USRA could file complaints before the Special Court, which had the power to determine whether the Conrail securities and the USRA bonds that the railways were to receive as compensation for their properties that had been taken by the government satisfied the constitutional minimum. The Special Court was to adjust the compensation if it determined that it was either too high or too low. *See* 45 U.S.C. § 743(c) (Special Court to assure that trans-

feror railroads receive "fair and equitable" value for their rail properties and that they receive no less than the constitutional minimum).

The bankrupt railroads' major creditors challenged the constitutionality of the Rail Act almost immediately. They argued *inter alia* that the act was an unjustifiable taking without just compensation. In the compendious *Blanchette v. Connecticut General Insurance Corps.*, 419 U.S. 102 (1974), the Supreme Court upheld the constitutionality of the Rail Act against a variety of constitutional challenges. In responding to the just compensation challenge, the Court stated that because the Tucker Act, 28 U.S.C. § 1491 (1982), was available to aggrieved transferors, enabling them to challenge their allotted compensation in the United States Claims Court, there was no unjust compensation problem. *Id.* at 148-49.

B. *Congressional Response to* Blanchette

In the wake of *Blanchette,* Congress was faced with the spectre of Tucker Act suits by virtually every creditor of the defunct railroads whose properties were to become part of the Conrail system. To avoid the confusion and uncertainty that would ensue if such suits were allowed, Congress amended the Rail Act in the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976), (the Reform Act), *codified in* 45 U.S.C. § 801 (1982), which changed the manner of compensating the transferor railways. Instead of simply putting Conrail securities into the Special Court's coffers, the Reform Act required Conrail to deposit with the Special Court securities *and* Certificates of Value (CVs), issued by the USRA. Pub. L. No. 94-210, Title VI, § 610(b),

90 Stat. 101, 104 (1976), *codified at* 45 U.S.C. § 746 (1986). The CVs, which are debt instruments, were designed to give the Special Court some flexibility in compensating the transferors, so that the Tucker Act suits could be avoided. Because CVs are at the heart of this case, it is necessary to discuss them in some detail.

According to the Reform Act, each transferor of rail properties was to receive a separate "series" of CVs. Each transferor would get as many CVs as it did shares of series B preferred Conrail stock in exchange for its properties. 45 U.S.C. § 746(b). Although the CVs paid no interest or dividend, they were guaranteed by the USRA and redeemable by the USRA on December 31, 1987, or at such earlier time as the USRA might determine. 45 U.S.C. § 746(c). Each CV had a *base value* that was determined as follows:

> (A) take the net liquidation value of a transferor's assets, as calculated by the Special Court;
>
> (B) subtract the value of other benefits already provided to the transferor under the Rail Act;
>
> (C) add any amount required to compensate for "unconstitutional erosion" that had occurred during the bankruptcy proceedings;
>
> (D) add 8% interest from the date the assets were transferred to ConRail to the date the CV is redeemed; and,
>
> (E) divide the resultant value by the number of CV's distributed to the transferor.

45 U.S.C. § 746(c)(4).[1] Base value is important because it is used to determine redemption value: redemption

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1. The text is a paraphrase of § 746(c)(4), which reads in its entirety as follows:

(Continued on following page)

value of a CV equals its base value on the redemption date; minus (A) the sum of the fair market value of the series B preferred stock and common stock and all dividends paid on that stock, and; (B) any other sums paid the transferor for its assets; divided by the number of CV's distributed to the transferor, 45 U.S.C. § 764(c)(2). *See also In the Matter of Valuation Proceedings Under Sections 303(c)*

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(Continued from previous page)

The base value of each certificate of value of any series shall be the value obtained by (A) taking the net liquidation value, as determined by the special court, to which the transferor to whom such series of certificates of value is issued is entitled by virtue of transfers of rail properties, under section 743(b)(1) of this title to the Corporation or a subsidiary thereof; (B) subtracting the value of other benefits provided under this chapter, as determined by the special court; (C) adding such amount, if any, as the special court may determine shall be required after taking into consideration compensable unconstitutional erosion, if any, in the estate of a railroad in reorganization, or of a railroad leased, operated, on controlled by such a railroad, which the special court finds to have occurred during any bankruptcy proceeding with respect to such railroad; (D) adding interest from the transfer date to the redemption date to be compounded annually at a rate of 8 percent per annum; and (E) dividing the resulting value by the number of certificates of value of such series distributed to such tranferor. In determining such base value, the special court shall give due weight and consideration to the finding of the Association as to the net liquidation value to which each tranferor is entitled by virtue of conveyances of rail properties under section 743(b)(1) of this title. For purposes of this paragraph, the term "rail properties" includes all rights with respect to employee benefit plans transferred and assigned to the corporation pursuant to section 743(b)(6) of this title. Net liquidation value with respect to such rights shall be determined after taking into account all obligations finally transferred or assigned to the Corporation pursuant to such section.

*and 306 of the Regional Rail Reorganization Act*, 425 F. Sup. 266, 276 (Special Court, 1976).

As a result of this formula, the CVs were "adjusters," for their redemption price was, by definition, the difference between liquidation value of the transferor's assets and the value of any other compensation given to the transferor. The CVs were intended to fill any gap in compensation caused by the low value of Conrail stock and USRA bonds. They were designed to ensure that all transferors received their constitutional due, so that there would be no Tucker Act suits against the United States.

At the same time that Congress passed the Reform Act, it also passed the Act of March 31, 1976, Pub. L. No. 94-253, 90 Stat. 295 (1976), which added 26 U.S.C. § 374(c) to the Internal Revenue Code. Section 374(c)(1) provides:

> No gain or loss shall be recognized if, in order to carry out the final system plan, rail properties of a transferor railroad corporation are transferred to the Consolidated Rail Corporation (or any subsidiary thereof) pursuant to an order of the special court . . . in exchange solely for stock of [Conrail], certificates of value of the [USRA], or any combination thereof.

C. *Conrail's Performance from 1976 through 1981*

Conrail's performance in the second half of the decade of its birth did not meet expectations. Instead of gradually decreasing its reliance on federal assistance and loans, Conrail grew ever more dependent on federal help, and its stock remained virtually valueless. In August, 1981, in response to this poor performance, Congress amended the Rail Act for the second time relevant to this suit. This

amendment, Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 357, 643 (1981) (Omnibus Reconciliation Act), *codified at* 45 U.S.C. § 1115 (1982), stated that "[f]or the purpose of computing the amount for which certificates of value shall be redeemable under § 746" all series B preferred and common stock that had been intended as consideration for the transferors' property was to be deemed to be without fair market value. As a result of the Omnibus Reconciliation Act, CVs, which had originally been intended as "gap fillers" between the value of the Conrail stock and the liquidated value of the transferred property, became the sole source of payment from Conrail to the transferor railroads.

## II. HISTORY OF THIS CASE

The factual background of this case stems from the time when railroads were in their heyday and faith in their future was unbounded. Plaintiffs-appellees are escrow agents for Delaware and Bound Brook Railway Company ("D&BB") which, in 1879, leased all of its rail properties to the Reading Company for 990 years. Almost 100 years later, in 1973, the Reading Company was one of the major northeast railroads that went into bankruptcy. Although D&BB was solvent, the Final System Plan adopted by USRA encompassed its property too, because of D&BB's long-term lease with the bankrupt Reading Company. Pursuant to the Final System Plan, D&BB's property was transferred to Conrail on April 1, 1976. Conrail stock and CVs were deposited with the Special Court until the value of D&BB's assets could be calculated.

USRA assessed the value of D&BB's contribution as approximately $1,150,000. App. at 10 (Malyska affidavit). Arguing that this figure was too low, D&BB filed a complaint with the Special Court, as was its right. In August, 1981, shortly after the Omnibus Reconciliation Act was passed, and while the suit was still before the Special Court, D&BB and USRA entered into a settlement agreement, a condition of which was that D&BB's stockholders adopt a complete plan of liquidation pursuant to 26 U.S.C. § 337.[2] The shareholders adopted a satisfactory plan in September, 1981.

In accordance with the settlement agreement, D&BB received CVs worth $6,802,660. This figure was arrived at by following the procedure prescribed in 45 U.S.C. § 746(c)(4), *see supra* at 6 (outlining procedure) and n.1 (text of § 746(c)(4)). Specifically, the figure was arrived at as follows: the parties agreed that the net liquidation value of D&BB's rail properties on April 1, 1976 was $4,408,417, *see* 45 U.S.C. § 746(c)(4)(A); they agreed that there had been no other benefits conferred, and that there was no compensation necessary for "unconstitu-

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2. Section 337 states that if a corporation distributes all of its assets within twelve months after adopting a complete plan of liquidation, no gain or loss will be recognized on any sales or exchanges of its property during that period. The statute reads, in relevant part, as follows:

> (a) General rule.—If, within a 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

tional erosion," *see* 45 U.S.C. 746(c)(4)(B), (C); they computed 8% annual interest on the net liquidation figure from April 1, 1976, the date the assets were transferred to Conrail, *see* 45 U.S.C. § 746(c)(4)(D); and, finally, they calculated the sum of the net liquidation value and the interest, *id.* Because the interest figure was $2,394,243, the sum of the interest and the liquidation value was $6,802,660.

USRA redeemed the CVs almost immediately for the full $6,802,660. D&BB thereupon liquidated pursuant to 26 U.S.C. § 337, its shareholders receiving *pro rata* shares of the proceeds. D&BB dissolved on December 31, 1981. A reasonable amount was left in a liquidation trust for payment of contingent obligations.

Thereupon, D&BB sought a private letter ruling from the IRS concerning the tax treatment of the interest component of the CVs. D&BB submitted that the interest component was a return on capital and therefore should be taxed as a capital gain. The IRS disagreed, however, and stated that the interest was not from the sale of assets but was ordinary income whose tax treatment was governed by 26 U.S.C. § 61(a) (1982). *See* Appellant's Appendix at 31-32 (IRS letter ruling of May 14, 1982).

D&BB then sought a second letter ruling, this time arguing that since the redemption was a sale pursuant to a § 337 liquidation, there should be no recognition of the gain and no taxation. *See supra* n.2. Once again, however, the IRS ruled against D&BB, stating that although the liquidation had followed all the requirements of § 337, the non-recognition treatment would not be extended to the 8% increment because that increment "did not constitute

proceeds from the sale or exchange of a capital asset," but was simply interest income, which is taxed even if received during the course of a § 337 liquidation. *See* Appellant's Appendix at 33-36 (IRS letter ruling of July 13, 1982).

On September 9, 1982, D&BB filed its federal corporate income tax form for 1981. In compliance with the letter rulings, D&BB reported interest income of $1,195,728,[3] on which it paid a tax of $545,153. On December 9, 1983, however, D&BB filed an amended return, claiming that the interest component should not have been taxed at all. Unmoved, the IRS continued to treat the interest as ordinary income.

D&BB thereupon filed a suit in the federal district court for the District of New Jersey seeking a refund. The government moved to dismiss and D&BB filed a cross-motion for summary judgment. As explained by the district court, the cross-motions focused on a single issue:

> whether the interest received by D&BB represents an amount in excess of the value of its assets, or whether the interest is, pursuant to 45 U.S.C. § 746(c)(4), a component of the actual value of the assets, and therefore not interest at all.

App. at 125.

After hearing argument, the district court denied the government's motion to dismiss and granted summary judgment for D&BB. According to the court's analysis, the critical question was whether the interest was intended

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3. This is D&BB's share of the total interest on the CVs paid by Conrail. The remainder was attributed to lessee Reading Company. The attribution is not in question here.

as (i) an element of base value, or (ii) an excess over value, payable presumably for the period between the seizure of the rail property on April 1, 1976 and the redemption of the CVs. If the interest were an element of base value, then, the district court felt, § 374(c) protected it from taxation; if the interest were an excess over base value, then it would be taxed as ordinary income. *See* App. at 127-28.

After describing the issue in these terms, the court decided that the interest provided for by statute was "a component of the base value of the certificates of value.... The interest component is thus an integral part of the redemption, or base, value for rail properties, and is not an amount in excess of the value of such properties." *Id.* at 130. Thus, it concluded, "[u]nder the express provisions of § 374(c) the aggregate sum received should result in no tax consequences to D&BB." *Id.*[4] The court thus ordered the IRS to refund the full amount of the $545,153 to D&BB.

The government appealed. Because the case involves solely questions of law, our scope of review is plenary.

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4. *See also* App. at 127:

> [T]he Rail Acts of 1973 and 1976 were complex acts enacted to deal with a crisis in rail transportation. The 1976 Rail Act established formulas for ensuring that railroads that turned over their property to Conrail received the constitutional minimum for that property. *The fact that interest is included as a factor in a formula for determining the base value of the USRA certificate of value, means that the interest factor cannot simply be assumed to represent an excess over the value of the property* ....
>
> (emphasis supplied).

## III. DISCUSSION

Although the papers are not entirely clear on the point, it appears that D&BB has essentially two theories according to which it should not be taxed on the 8% interest component. The first theory is simply that § 374(c) in terms proscribes taxation of any income received upon the redemption of the CVs. The second theory is that the 8% interest component is capital gain that by virtue of § 337 is non-taxable. Although the district court relied on the former theory, D&BB presents both here, and we consider them both. We then address two arguments presented by D&BB for limited taxation.

### A. *The Relevance of Section 374(c)*

D&BB argues that 26 U.S.C. § 374(c) (1982) controls this case because of its instruction that the exchange of rail properties for Conrail securities and CVs is not a recognition event. Since non-recognition events cannot give rise to taxation, D&BB argues, the clear import of § 374(c) is that there can be no taxation on any part of the CVs received from Conrail, even on interest. Appellee's Br. at 13-14. The district court also relied on this statutory provision in finding for D&BB. *See supra* at 13.

Despite the district court's reliance on it, we believe that § 374(c) is not relevant to the issue in this case. Section 374(c) provides non-recognition treatment for the *exchange* of the railway property for the Conrail securities and CVs. However, we are concerned here not with the exchange of D&BB's assets for CVs but with the subsequent *redemption* of the CVs by the USRS. The exchange in this case which took place before the redemption, was not taxed. Redemption is a wholly different transaction

from the initial exchange of property for securities, and § 374(c) does not pertain to it. Section 374(c) rendered only the exchange non-taxable, and canont help taxpayer any more.

B. *Characterization of the 8% Interest Component*

The parties agree that if the 8% interest component is treated as capital gain, it is not taxable on account of § 337. Their disagreement centers on whether the component is ordinary income or capital gain. We believe that the interest is ordinary income for two principal reasons. The first involves literal statutory construction. Section 61(a)(4) of the Internal Revenue Code, 26 U.S.C. § 61(a)(4) (1982), states that interest income is taxable as ordinary income. The Supreme Court has stated that that section is to be broadly construed, and all exemptions from it construed narrowly. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955). The plain language of 45 U.S.C. § 746(c)(4) (quoted *supra* n. 1), which defines the value of CVs, expressly uses the term "interest" without qualification. On account of the express terms of 26 U.S.C. § 61(a)(4) and 45 U.S.C. § 746(c)(4), and the pertinent rules of statutory construction, the interest component of CVs must be treated as ordinary income and are fully taxable.

The second reason for treating the interest component as ordinary income is more analytic, but it is closely related to the first reason. This argument takes as its starting point the definition of interest: "compensation allowed by law or fixed by the parties for use, or forbearance, *or detention,* or money." *Fall River Electric Light Co. v. Commissioner,* 23 B.T.A. 168, 171 (1931) (emphasis

added). It is clear that if Conrail had issued the CVs and redeemed them on April 1, 1976, the day it took control of the rail property, there would be no payment based on the 8% interest calculation for the interest was to be calculated from the date on which the assets were transferred to the date on which the CVs were redeemed. Thus the "interest income" in this case is simply payment for the detention of money and falls squarely within the standard definition of interest. Because all other interest is taxed as ordinary income, this interest should be, too.

Strong support for this line of reasoning is found in *Kieselbach v. Commissioner*, 317 U.S. 399 (1943). *Kieselbach* involved a New York law that granted property owners whose property had been condemned interest from the date the city took title to the date of payment "as part of the compensation to which such owners are entitled." The Supreme Court held that the interest was ordinary income under the predecessor of § 61(a):

> [T]hese [interest] payments are indemnification for delay, not a part of the sale price. While without their payment just compensation would not be received by the vendor, it does not follow that the additional payments are a part of the sale price under § 117(a). The just compensation constitutionally required is not the same thing as the sale price of a capital asset.

317 U.S. at 404. The point of *Kieselbach* is that even though it was constitutionally required ("[w]hile without their payment, just compensation would not be received by the vendor"), the interest was not part of the sale price of the capital asset, but was fully taxable as ordinary income. That is exactly the case here: although the interest may have been constitutionally required, as the

district court found, *see supra* at 13-14 & n.4, it is nonetheless interest income that must be taxed as ordinary income.

D&BB offers several arguments against this position. Although some of them are strong, we find none of them sufficient to overcome the weight of the arguments just considered.[5]

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5. In addition to the arguments addressed in the text, D&BB made two other arguments. First, D&BB argued that the interest component of the CV could not be taxed differently from the rest of the CV because the interest component was an "integral part" of the CV, and thus distinguishable from standard instances of interest in which the money paid is added on at the end. Appellee's Br. at 14-22. At its root, the argument is that the fact that interest is part of the definition of base value implies that Congress intended it to be "an inherent and inseparable part" of the CVs, *id.* at 15, and that because the CVs are exchanged for capital goods, the entirety of the CVs must be treated as proceeds from the sale of capital goods. The argument relies on the unspoken premise that a court should not treat different components of the CVs differently.

   Stating the premise reveals its weakness. There is no general, jurisprudential ground supporting the proposition that a court should not divide awards into their component parts. The *Kieselbach* Court did precisely that, treating part of the compensation price as return on capital and part as interest (ordinary income). Surely Congress could have instructed that the interest component of the CVs be treated as return on capital. It did not, however, choose to do so.

   D&BB's other argument that is not addressed in the text begins with the proposition that it is unfair to have different tax consequences hinge upon the form of payment received, especially when that form is beyond the control of the taxpayer. Appellee's Br. at 22-25. Taxpayer then observes that if it had been paid in Conrail stock, as was originally intended, *see supra* at 7-8, it would have had no ordinary income. Thus, taxpayer concludes, the mere fact that it has not been paid in Conrail stock but has instead received CVs should not change the fact that it has not received, and should not be taxed on, ordinary income. Appellee's Br. at 22-25.

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First, D&BB notes that it is entitled to 8% interest on the net liquidation value of the assets it gave to Conrail, compounded annually. It further notes that the 8% is calculated from that net liquidation value, *regardless of what other payments taxpayer may get from Conrail. See* supra at 6 (paraphrasing 45 U.S.C. § 746(c)(4)). Thus, it concludes, the interest cannot represent payment for the detention of money, for it is calculated without regard to the precise amount of money D&BB has in fact "lent" the government. Therefore, says D&BB, the term "interest" income is a misnomer for this component of the CVs, for the 8% is in fact a measure of the appreciation of the capital seized by the government. Appellee's Br. at 22. Hence, D&BB argues, the 8% falls under the § 337 prohibition against taxation.

D&BB's initial observation is correct: if the interest figure is intended to be payment for the detention of the transferor railroads' money, then it is incorrectly calcu-

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We disagree with the initial proposition of this argument. The tax consequences of a transaction will almost always depend upon whether the payment received is in the form of debt or equity and the form of payment is often out of the hands of the recipient (as, for example, in large corporate transactions where small shareholders have little say about whether they will receive debt or equity instruments). Granted, from D&BB's perspective it is *unfortunate* that D&BB is burdened by heavier tax consequences on account of being paid in CVs rather than in Conrail stock, but, because D&BB never had a right to payment in Conrail stock, *see infra* at 28, we find nothing unfair about this circumstance.

lated because it does not take into account all transfers from Conrail to the transferors that might occur between the date the transferor gets its CVs and the redemption date. Despite the technical correctness of this point, we are not persuaded that it is sufficient to overcome the arguments in favor of taxing the interest components of the CVs as ordinary income. In the first place, taxpayer's alternative explanation for the 8% payment has a fatal flaw. The transferred rail property presumably *depreciated,* rather than appreciated, between the time it was transferred and the redemption date. It thus makes little sense to speak of capital appreciation in this context.

Moreover, even a sympathetic reinterpretation of D&BB's argument does not lead to the conclusion urged upon us by D&BB. One might interpret D&BB's reference to the 8% component as "capital appreciation" to mean that the 8% payment was intended as a substitute for the estimated profit that D&BB would have realized had the property remained in the hands of the Reading Company, D&BB's lessee. The 8% would not then represent "capital appreciation," as that term is generally used, but would represent a substitute for the profit that the capital would have created. Although this interpretation avoids the problem of the depreciation of capital assets that we have just noted, it still does not lead to the conclusion that the 8% payment should be treated as other than ordinary income. The actual profits that D&BB would have made had its property not been transferred would be taxed as ordinary income, and it stands to reason that the substitutes for those profits should be taxed in the same way. Thus, even under this interpretation, we do not reach the conclusion that the 8% payment should be treated as a return on capital.

We are thus left with an 8% figure that does not fit neatly into any category of income. Given this imprecision, we are inclined to think that, despite the problem correctly noted by taxpayer, the 8% figure is best treated as ordinary interest. The statute consistently referred to it as such, and that seems to be persuasive evidence that Congress intended it to be treated as ordinary interest. Most likely, Congress simply wanted to keep the calculations simple, and thus ignored the complications that would have arisen if it had insisted that the interest figure take into account the putative payments[6] from Conrail to the transferor railroad during the period between distribution of CVs and the redemption date. The mere fact that the interest component was not computed with scientific precision does not outweigh the strong evidence in favor of treating this amount as ordinary interest.

D&BB's second argument is that although *Kieselbach* would control if the Rail Act and the subsequent statutes that amended it were *condemnation* statutes — ones under which the government seizes property for a public use and is required to pay just compensation — the Rail Act was not a condemnation statute but a *reorganization* (bankruptcy) statute, promulgated pursuant to the Congress' bankruptcy power, rather than its condemnation power, and therefore that an entirely different analysis applies. *See* Appellee's Br. at 33-39. According to D&BB, because the Rail Act is a reorganization statute, the inter-

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6. It is irrelevant that D&BB itself received no other payments from Conrail, for D&BB's argument, is that the method of interest calculation reveals Congress' intent about the nature of the payments. That intent does not depend on the particular facts of this case.

est component of the CVs is "boot" which is taxed only to the extent of gain realized, and the nature of the gain — ordinary income or capital gain — is determined by the nature of the assets for which the boot was received.[7] Because in this case the transferred assets were capital goods, D&BB argues, the interest is a capital asset, and the gain attributable to the interest is cancelled by the § 337 distribution, *see supra* n.2 (discussing § 337).

D&BB relies on *Blanchette v. Connecticut General Insurance Corps.*, 419 U.S. 102 (1974), for the proposition that the Rail Act is not a condemnation statute but a reorganization statute. In *Blanchette*, the Court was presented with the question whether the Rail Act worked an unjustifiable taking without just compensation. Although the Court engaged in a careful discussion suggesting that the Rail Act's scheme of compensation satisfied the requirements of the eminent domain power, *see id.* at 149-51, it did not rest on that line of reasoning. Instead, the Court concluded that the question was merely academic, for "the arguments in favor of [characterizing the Rail Act as an eminent domain statute] have no merit." *id.* at

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7. When like-kind properties are exchanged, as in reorganization proceedings, each property's basis "carries over," and neither gain nor loss is recognized on the transaction. *See* 26 U.S.C. §§ 1031 (like kind exchanges), 354 (corporate reorganizations). If one party to a like-kind exchange also contributes some other property, then that property is called "boot." The person who receives the boot recognizes gain (if any) only to the extent of the boot. *See id.* The character of the underlying property transferred in the like kind-exchange, not the character of the boot, determines the character (capital or ordinary) of the gain. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 3-21 - 3-22 (1979).

152. Instead, the Court found that the Rail Act was an exercise of Congress' powers under the bankruptcy clause, U.S. Const. Art. I § 8, cl. 4.

While *Blanchette* would appear at first blush to be dispositive in D&BB's favor, a closer look at the Court's analysis of the issue suggests that this is not so. The Court gave three reasons for its determination that the Rail Act was a reorganization rather than condemnation statute: (1) Conrail was to be "basically a private, not a governmental, enterprise," *id.* at 152; (2) that the Rail Act compelled the exchange of property did not disqualify it from being a reorganization statute, for cram-downs are forced exchanges, and they are authorized by the bankruptcy statute which is, clearly, an instance of Congress' powers under the bankruptcy clause, *id.* at 152-53; and, (3) there were ample safeguards of judicial review to make this a reorganization statute, *id.* at 154. Only the first of the *Blanchette* Court's reasons explains why the Rail Act must be a reorganization statute and cannot be a condemnation statute. The second and third parts are simply reasons that the Rail Act *is not disqualified from being* a reorganization statute; obviously, they do not disqualify the Rail Act from also being a condemnation statute. The controlling power of the *Blanchette* Court's characterization of the Rail Act therefore depends upon the first part of the explanation. However, the first part of the explanation is no longer true: as noted above, the plans for a private Conrail failed. In response to that failure, Congress passed the Omnibus Reconciliation Act, under which Conrail is, and has been at least since that

act, primarily a governmental enterprise. It is thus open to doubt that *Blanchette* controls on this point today.[8]

We need not decide this question, for even assuming that the Rail Act is indeed a reorganization statute rather than a condemnation statute, we are not persuaded that the treatment of the interest should be any different under the one than under the other. *Kieselbach's* holding that any money paid for delay on payment—even money that is constitutionally required—is fully taxable as interest did not depend upon the nature of the underlying statute as a condemnation statute. *Kiselbach* is thus on all fours with this case, and controls it, regardless of whether the Rail Act is characterized as a condemnation statute or a reorganization statute.[9]

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8. Even before the Omnibus Reconciliation Act, the Special Court, the court most directly responsible for and experienced with carrying out the Rail Act, had expressed its discomfort with interpreting the Rail Act as belonging entirely to either the reorganization or the condemnation categories of statutes. Judge Friendly, speaking for the court, explained that the Rail Act "drew both on the bankruptcy power and on the authority of Congress to exercise eminent domain under the commerce power." Norwich & Worcester Railroad Co. v. United States, 408 F. Supp. 1398, 1404 (Special Court 1976) (Friendly, J.). The Omnibus Reconciliation Act only deepened the ambiguity concerning the nature of the Rail Act.

9. *Commissioner v. Carman,* 189 F.2d 363 (2d Cir. 1951), relied upon by D&BB, is not to the contrary, in that case, the taxpayer had bought bonds of a corporation that filed a petition for reorganization in 1935 under the then-prevailing bankruptcy act. *Id.* at 364. Almost five years later, in 1939, a reorganization plan was approved by the district court. *Id.* Consummation of the plan was delayed for five more years by litigation, and it was not until December 29, 1944 that the plan finally went into effect. *Id.* On that date, the

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D&BB's third argument proceeds from an observation about the allocation of basis between Conrail securities and CVs, and the alleged inequities that might result from that allocation if D&BB cannot treat the 8% interest component as capital income. Basis is allocated between the CVs and the Conrail stock in direct proportion to their fair market values. Treas. Reg. 1.358-5. The fair market

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taxpayer surrendered his old bonds and received in return bonds, common and preferred stock in the reorganized corporation, and cash. *Id.* The cash was ordered by the district court as an "adjustment payment" to compensate the taxpayer for the five-year delay in the consummation of the plan from 1939 to 1944. *Id.* Although the tax court held that the "adjustment payment" was fully taxable as interest income (income for the detention of money), *id.*, the circuit court reversed, holding that the adjustment payment was payment " 'in pursuance of the plan of reorganization,' " *id.* at 365 (quoting 26 U.S.C. § 112(b)(3), which was the predecessor of 26 U.S.C. § 354), and was thus taxable as boot, and not as ordinary income.

D&BB argues that the lesson of *Carman* is that payment for the delay in a reorganization proceeding is necessarily boot, not interest, and urges us to treat the 8% interest component of the CVs in the same way. We decline to read *Carman* that broadly. The key to the *Carman* holding was that until the date when the reorganization plan was finally consummated, December 29, 1944, the taxpayer retained possession of his old bonds. The taxpayer had full control over the bonds during the period of litigation; he could have sold them or transferred them at will. Because there was no time-gap between the taxpayer's surrender of his bonds and his receipt of property in exchange for the bonds, treating the adjustment payment as interest would have been inappropriate. Here, by contrast, D&BB gave up all rights to its property in April, 1976, and there was a delay of several years between D&BB's surrender of assets and the receipt of consideration for those assets. The money attributable to the delay is properly treated as interest, for it falls squarely under the definition of interest, *see supra* at 15-16, as the adjustment payments in *Carman* did not.

value of the CVs includes the value of the CVs attributable to the 8% interest. D&BB notes that because the 8% interest figure is included in the basis calculations the CVs will have a relatively larger basis attributed to them than will the Conrail stock. So long as that interest component is treated as ordinary income, D&BB warns, D&BB might realize (1) an excessive capital loss on the CVs, (2) an excessive capital gain on the stock, and (3) a large measure of ordinary income on the interest component. If the sale of the CVs and stock were sufficiently far apart, D&BB continues, the capital loss on the CVs could not be offset against the gain on the stock and could be offset only to a limited extent against the ordinary interest income. Appellee's Br. at 46-47. *See also* 26 U.S.C. §§ 1211, 1212 (1982) (governing treatment of capital losses). The net result could be a transaction in which D&BB loses money, and yet on which it is (a) taxed on ordinary income, and (b) it is left with a large, unuseable, capital loss. Only if the interest is treated as capital income. D&BB argues, will the inequitable result of the allocation of basis be avoided. Appellee's Br. at 47-48. (And, of course, if the interest component is treated as capital income, it will escape taxation entirely under § 337.)

D&BB's argument is unpersuasive because it is inconclusive.[10] Treating the interest component of the CVs

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10. We do not agree with the government's response to this argument that insofar as it has been clear since 1981 that transferor railroads would receive no stock, allocation of basis is a purely academic question. Gov. Rep. Br. at 9. The point of the taxpayer's argument is that the basis provision, Treas. Reg. 1.358-5, may provide evidence about how Congress thought about the taxability of the 8% interest, and that is precisely the question before us here. Therefore, even if the basis provision itself is not relevant, it may still guide our interpretation of the statute.

as ordinary income may indeed result in an unuseable capital loss on the sales of the CVs and in ordinary income; it may, that is, result in taxation even though D&BB suffers a net loss on the transaction. This result is, however, a function of (1) the mechanical, ultimately arbitrary, rules concerning the length of time that one may carry over capital gains or losses, and (2) our tax system's differentiation between capital gains and losses on the one hand and ordinary gains and losses on the other. On account of the carry-over rules and differentiation between capital and ordinary income, it is frequently the case that some losses cannot be set off against certain gains, either because the losses occurred too far before the gains or because the losses belonged in the capital account whereas the gains did not. That this might have happened here cannot be determinative of our interpretation of the Rail Act.

C. *D&BB's Arguments for Limited Taxation*

In addition to the arguments recounted above as to why D&BB should pay no tax on the redemption of the CVs, D&BB offers two arguments that apparently admit of some taxation, but less than that demanded by the government. In the first of these arguments D&BB points out that the 1973 and 1976 Acts clearly contemplated that transferor railways would have equity holdings in Conrail, and would not be creditors. Appellee's Br. at 25-28. D&BB lost its expectation of being a Conrail equity holder only on August 13, 1981, when the Omnibus Reconciliation 981 Act was passed. D&BB concludes that it became a creditor only on that date, and therefore can be taxed only for interest accruing after that date. Under this

theory no interest that accrued before August 13, 1981 would be recognized. Appellee's Br. at 30.

D&BB effectively asks to be treated as if it held common and preferred Conrail stock, or had a right to hold such stock, until August 13, 1981, and then was forced to exchange its stock for CVs. However, D&BB did not hold anything before the Omnibus Reconciliation Act; it had only a claim to a certain amount of compensation in whatever form Congress saw fit to provide. Admittedly, until August 13, 1981, D&BB may have *expected* that it would receive equity instead of ordinary income, but it had no *right* to such payment. (There was no reliance on equity payment, for the exchange of assets was forcible.) D&BB thus mischaracterizes the effect of the Omnibus Reconciliation Act, which was simply a determination of the form of compensation D&BB would receive for its properties.

Another reason the argument fails is that on August 13, 1981, Conrail equity was virtually worthless. This means that even had the law not changed on August 13, 1981, Conrail would have received all CVs anyway. It is thus inaccurate to say that D&BB swapped equity for debt on August 13, 1981. The change in law simply ratified something that would at all events have happened.

Finally, D&BB argues that the "open transaction" rule is relevant to its case. According to this rule, first enunciated in *Burnet v. Logan*, 283 U.S. 404 (1931), and subsequently modified by 26 U.S.C. §§ 453, 483, when a taxpayer receives goods over a period of time in exchange for some property, and the value of the goods to be received is not easily calculable, the taxpayer is taxed as he receives the goods, with the recovery of basis prorated

over the term of the payment. The character of any gain received is determined by the character of the property transferred. The taxpayer is thus not forced to approximate the total value of the stream of goods before he has received them. *See Burnet v. Logan, supra;* M. Chirelstein, *Federal Income Taxation* 244-48 (1982).

D&BB argues that its receipt of the CVs is akin to an open transaction because until November 1981 when received the CVs from the USRA, this was an open transaction, the value of the goods that D&BB was to receive not yet having been determined: "[a]ny gain which may be attributable to the D&BB from the 1976 transaction would be capital gain, deferred and not reportable until November 13, 1981 when the D&BB's receipt of the Certificates of Value had the effect of closing the transaction." Appellee's Br. at 44. Although D&BB does not explain the tax consequences of this analysis, it would appear that any interest that accrued before November 13, 1981 would be capital gain, and hence not taxed, whereas the income accruing after that date (a *de minimis* amount to be sure), would be taxed as ordinary income.

This analysis fails because there is no open transaction problem in this case. The open transaction doctrine concerns the taxability of payments when those payments will continue over a long period and when the total is unknowable. *See id.* Here, by contrast, the redemption of the CVs was the first and final payment from the government to D&BB. It was definite and calculable, and the government did not attempt to tax D&BB for any income that it might receive in the future. It is irrelevant that the value D&BB would receive was not known on April

1, 1976, when D&BB transferred its property to the USRA, for the government did not try to tax D&BB until D&BB had received full compensation for its transferred rail properties. Open transaction analysis is therefore inappropriate here, and D&BB's final argument must also be rejected.

## IV. CONCLUSION

As the foregoing discussion makes clear, D&BB's counsel has presented us with a number of sophisticated challenges to the government's position. For the reasons stated above, however, we find that the interest income of approximately one million dollars received by D&BB on the redemption of its CVs should be taxed as ordinary income. The judgment of the district court will therefore be reversed, and an order entered directing the district court to enter judgment for the government.

A True Copy:

Teste:

*Clerk of the United States Court of Appeals for the Third Circuit*

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civil No. 84-3418

RICHARD DRAYTON,
JOHN R. SAUERTEIG and
SYDNEY G. STEVENS,
as escrow agents of THE DELAWARE & BOUND BROOK RAILROAD COMPANY,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

MEMORANDUM OPINION

Newark, New Jersey
April 8, 1985

BEFORE: The Honorable DICKINSON R. DEBEVOISE, U.S.D.J.

*Introduction*

This is an action brought by a taxpayer, the Delaware & Bound Brook Railroad Company (D&BB) by its escrow agents, Richard Drayton, John R. Saverteig and Sydney G. Stevens, to obtain a refund of income tax from the United States. The government seeks to dismiss the complaint, and plaintiff has cross-moved for summary judgment. These motions are now before the court.

*Statement of Facts and Procedural History*

Pursuant to a provision of the Regional Rail Reorganization Act of 1973, 45 U.S.C. 743(b), all of D&BB's rail properties were conveyed to Conrail on April 1, 1976.

Although D&BB itself was solvent, it was affected by the Act because, in May 1879, it had leased all of its rail and nonrail properties to the Reading Company for a period of 990 years. The Reading Company had, several years before the enactment of the 1973 Rail Act, filed a petition for reorganization and thus was one of the bankrupt railroads to be reorganized into Conrail. The Act provided that railroads not in reorganization that were leased, operated and controlled by a railroad in reorganization were to convey their rail properties to Conrail. 45 U.S.C. Section 716(d).

Pursuant to 45 U.S.C. Section 743(a), Conrail deposited Conrail securities and certificates of value issued by the United States Railroad Association (USRA) with a special court, as compensation for D&BB's properties. The certificates were guaranteed by the Secretary of Transportation, under 45 U.S.C. Section 746(a), and subject to redemption by the taxpayer at a later date, pursuant to 45 U.S.C. Section 746(c). The statute provided that the certificates were to be redeemed at "base value" by USRA on a date specified by it, after the special court had decided issues of valuation and compensation. Section 746(c)(4) sets forth the formula for computing the base value of each certificate of value. That formula is:

(a) The net liquidation value of a transferor's properties as of April 1, 1976 (net liquidation value to be determined by the special court); minus

(b) "other benefits" provided to a transferor under the 1973 and 1976 Acts; plus

(c) "compensable unconstitutional erosion" suffered by a transferor as a result of the 1973 and 1976 Rail Acts; plus

(d) interest from April 1, 1976 at the rate of 8% per annum, compounded annually; divided by

(e) the number of certificates issued to the transferor.

*See also In the Matter of the Valuation Proceedings Under Sections 303(c) and 306 of the Regional Rail Reorganization Act,* 425 F.Supp. 226, 276 (Special Court 1976).

The D&BB properties were assigned a net liquidation value by USRA in its Final System Plan. That value, however, was not accepted by D&BB which prosecuted the valuation issue before the special court. Malyska Aff. paras. 11, 12. At around the same time, D&BB and the Reading Company entered into an agreement resolving their disagreement as to their respective shares of the compensation to be obtained through the valuation litigation. The agreement, dated April 1, 1976, included a formula for allocating any compensation paid to D&BB for its rail properties transferred to Conrail. Malyska Aff. paras. 13, 14.

On August 13, 1981, the Omnibus Budget Reconciliation Act of 1981 amended existing law by eliminating Conrail securities as a payment medium and by directing that for purposes of computing the amount for which certificates of value were redeemable, the Conrail securities had no fair market value.

On August 25, 1981, D&BB and USRA entered into a settlement agreement (the D&BB/USRA Settlement Agreement) pursuant to which D&BB's rail properties were agreed to have had a net liquidation value of $4,408,417. *See* D&BB/USRA Settlement Agreement,

Malyska Aff., Exhibit A. The D&BB/USRA Settlement Agreement was not to have any force and effect until two conditions were satisfied: (1) approval of the settlement by the special court; and (2) approval of the settlement by D&BB's stockholders.

On September 24, 1981, D&BB's stockholders approved the D&BB/USRA Settlement Agreement provided that the settlement was an integral part of a plan of complete liquidation which D&BB's stockholders adopted on that same date. *See* Plan of Complete Liquidation, Malyska Aff., Exhibit B. On November 13, 1981 D&BB received from the special court certificates of value worth $6,802,660 which, upon the execution of settlement papers, were redeemed by USRA for that sum. The proceeds were first shared with the Reading Company, according to the D&BB/Reading agreement, and all remaining assets were liquidated and distributed to D&BB stockholders, with the exception of funds transferred to a liquidation trust for payment of contingent obligations. Malyska Aff. paras. 22-24. D&BB was dissolved as of December 31, 1981. *Id.* at para. 25.

On December 21, 1981, D&BB wrote to the Internal Revenue Service, Assistant Commissioner, requesting a ruling concerning the character of the amount of proceeds received by D&BB upon redemption of the certificates of value that was attributable to the annual 8% accrual of interest. In its responsive ruling of May 14, 1982, the IRS held that the proceeds received by D&BB which were attributable to the 8% interest factor did not constitute proceeds from the sale or exchange of a capital asset, but constituted ordinary income upon which

D&BB was required to pay income taxes. Malyska Aff. para. 26.

In a ruling request dated March 4, 1982, D&BB provided additional information to the IRS in seeking a determination on the taxable consequences of its receipt and distribution of the redemption proceeds from its certificates of value. The IRS held that no gain would be recognized to D&BB for funds received in the exchange and then distributed, with the exception of amounts attributable to the 8% interest factor which would be considered interest income. Malyska Aff. para. 27.

On September 9, 1982, D&BB filed a United States Corporation Income Tax Return for calendar year 1981. In compliance with the tax rulings, but under protest and reservation of its rights, D&BB reported the amount attributable to the annual 8% interest factor, totaling $1,195,728 as interest income for 1981. Malyska Aff. para. 28. On December 9, 1983, D&BB filed an amended United States Corporation Income Tax Return (Form 1120x) for calendar year 1981 claiming that a total of $1,195,728 should have been properly treated as proceeds from the sale or exchange of its railroad property rather than an interest income. Since the gain on such exchange should not have been recognized, stated D&BB, a total of $545,153 had been illegally assessed and collected from D&BB because of the erroneous inclusion of $1,195,728 in its 1981 income. Malyska Aff. para. 29 and Form 1120, Malyska Aff., Exhibit C. More than six months passed from the time that D&BB filed its refund claim to the time it commenced this suit. No notice of disallowance of the claim has been mailed to D&BB by registered mail by the Commissioner of Internal Revnue.

Section 374 of the Internal Revenue Code, 26 U.S.C. Section 374, provides that receipt of Conrail securities or USRA certificates of value received in exchange for rail properties are not recognized as taxable gain. Both parties to this suit agree that, except for the amount received by D&BB representing the 8% interest factor, there is no dispute that the cash received upon redemption of the certificates of value is nontaxable.[1]

The government's motion to dismiss and D&BB's motion for summary judgment both focus on one issue. That issue is whether the interest received by D&BB represents an amount in excess of the value of its assets, or whether the interest is, pursuant to 45 U.S.C. 746(c)(4), a component of the actual value of the assets, and therefore not interest at all.

*Discussion*

The government has moved to dismiss D&BB's complaint for failure to state a claim upon which relief can be granted. The government contends that the $1,195,728 received by D&BB represents excess over the value of D&BB's rail property at the time of the taking, and therefore is interest taxable as ordinary income under IRC Section 61(a). In support of this contention, the government relies on two Supreme Court decisions: *Blanchette v. Connecticut General Insurance Corp.,* 419 U.S. 102 (1974) and *Kieselbach v. Commissioner,* 317 U.S. 399 (1943). In *Blanchette, supra,* the Supreme Court upheld the constitutionality of the Rail Act in that it provided for just compensation for the taking of property. At one point, the Court stated "As long as creditors are assured fair value, with interest, for their properties, the Consti-

tution requires nothing more." 419 U.S. at 156. The government seems to argue that, by this statement, the Supreme Court contemplated that the interest factor automatically represented an amount in excess of value. However, that reading gives much too specific an interpretation to a general statement. *Blanchette* does not consider the nature of the interest component in a tax context.

*Kieselbach, supra,* involved a municipal ordinance that required that a property owner be paid interest on a condemnation award from the date of condemnation to the date the award was actually paid. The Court held that the interest was indemnification for delay, not part of the sales price, and therefore taxable as ordinary income. 317 U.S. at 400-403. The government argues that the situation in the case at hand is exactly the same as in *Kieselbach,* and that that case is therefore dispositive of the instant case. I disagree. The case at hand is not a simple condemnation case; the Rail Acts of 1973 and 1976 were complex acts enacted to deal with a crisis in rail transportation. *See generally Blanchette, supra,* 419 U.S. at 108-117. The 1976 Rail Act established formulas for ensuring that railroads that turned over their property to Conrail received the constitutional minimum for that property. *See* 1976 U.S. Code Cong. & Admin. News at 106-107 (94th Cong. 2d Sess.). The fact that interest is included as a factor in a formula for determining the base value of the USRA certificates of value, 45 U.S.C. Section 746(c)(4), means that the interest factor cannot simply be assumed to represent an excess over the value of the property, as in *Kieselbach. Kieselbach* is not, therefore, dispositive, and the government's motion to dismiss D&BB's complaint is consequently denied.

D&BB has cross-moved for summary judgment pursuant to Fed. R. Civ. P. 56 on the grounds that the undisputed facts demonstrate that the 8% interest factor is a component of the base value of the certificates of value, and is not to be treated as taxable income. In a lengthy brief, D&BB has undertaken an exhaustive analysis of why the interest component is not to be treated as interest for tax purposes. The salient points of that argument are summarized below.

The language of IRC 374(c) clearly states that certificates of value (and Conrail securities) received in exchange for rail properties result in no tax consequences to the transferor of such property, and there is no question that the D&BB/USRA transaction constituted such an exchange. D&BB argues that the term "certificates of value" as used in IRC Section 374 has a specific statutory meaning which is set forth in 45 U.S.C. Section 746(c)(4). Pursuant to Section 746(c)(4), the base value of a certificate of value, or the value at which the certificate will be redeemed, is determined by taking the net liquidation value of a transferor's properties, subtracting other benefits received by the transferor under the Rail Act, adding compensable unconstitutional erosion, adding 8% per annum interest from April 1, 1976, compounded annually, and finally dividing the resultant value by the number of certificates of value held by the transferor. Thus, the 8% annual interest is one of several factors considered in determining base value, and D&BB therefore contends that the interest is an indistinguishable part of the certificate of value and must enjoy the same nonrecognition treatment as any other factor considered pursuant to Section 746(c)(4).

D&BB supports its argument primarily by reference to both explicit and implicit Congressional intent as evidenced by relevant legislative history. D&BB points out that Congress made no comment as to the 8% interest component and refers to the legislative history of the 1976 Rail Act in which Congress evidenced its belief that the redemption price of the certificates of value is the "constitutional minimum value of the rail properties transferred." 1976 U.S. Code Cong. & Admin. News at 107 (94th Cong. 2d Sess.). Since D&BB was to receive that minimum as a tax-free exchange for its rail properties, argues D&BB, no component used in determining that minimum can be considered a taxable gain.

Furthermore, D&BB contends that to tax the interest component would result in disparate tax treatment had Conrail securities continued to remain an item of exchange for rail properties. Under IRC Section 374, neither Conrail securities nor certificates of value taken in exchange for rail properties are considered taxable gain. Pursuant to that section, securities and certificates would have equal value, but securities would never have an interest component. Therefore, a transferor who received securities rather than certificates of value would never be subject to an IRS claim that any of its redemption proceeds constituted taxable gain. Thus, D&BB argues that disparate tax treatment under the same IRC provision would result.

Upon consideration of D&BB's arguments, and a review of the relevant statutes and the undisputed facts of this case, I conclude that D&BB is correct in its characterization of the statutory 8% annual interest as a component of the certificate of value, and not as taxable interest.

There being no genuine issues of fact precluding judgment for D&BB, I grant D&BB's motion for summary judgment.

The provisions of 45 U.S.C. Section 746(c)(4) include the 8% annual interest as a component of the base value of the certificates of value, and do not add the interest once the base value has been determined. The interest component is thus an intregal part of the redemption, or base, value for rail properties, and is not an amount in excess of the value of such properties. Under the express provisions of Section 374(c) the aggregate sum received should result in no tax consequences to D&BB. The computation of the base value of the certificates of value issued to D&BB, as set forth in the D&BB/USRA Settlement Agreement, reveals that that computation was done in accordance with the provisions of Section 746(c)(4). *See* Settlement Agreement, Table 1, Malyska Aff., Exhibit A. Therefore, the interest component was not a taxable gain to D&BB, and D&BB is entitled to a refund of the taxes it paid on that interest component in 1981.

*Conclusion*

The government's motion to dismiss D&BB's complaint is denied. D&BB's motion for summary judgment is granted.

Counsel for D&BB are requested to submit an appropriate form of order.

*Footnote*

1. Throughout the papers of both parties, the amount of interest at issue is stated to be $1,195,728, the non-

interest component to be $4,408,417, and the total to be $6,802,660. However, the two components actually total $5,604,145. The D&BB/USRA Settlement Agreement states that the interest component is $2,394,243, which, when added to the net liquidation value (noninterest), does total $6,802,660. *See* Agreement, Table 1, Malyska Aff., Exhibit A. It is not clear why the disparity in figures exists, but since it does not affect the disposition of these motions, it need not be considered here.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HONORABLE DICKINSON R. DEBEVOISE

Civil Action No. 84-3418-D

RICHARD DRAYTON, JOHN R. SAUERTEIG and SYDNEY G. STEVENS as escrow agents of THE DELAWARE & BOUND BROOK RAILROAD COMPANY,

Plaintiffs,

v. ORDER

THE UNITED STATES OF AMERICA,

Defendant.

(Original Filed May 6, 1985)

This matter having been opened to the Court on April 8, 1985 on the Defendant United States of America's Motion to Dismiss the Complaint (Robert L. Handros, Esq., Trial Attorney, Tax Division, U.S. Department of Justice appearing for Defendant United States of America), and on the Plaintiffs' Cross Motion for Summary Judgment (John N. Malyska. Esq. and Henry T. Benedetto, Esq. both of Meyner and Landis, Esqs. appearing for the Plaintiffs), and the Court having considered the moving papers, the Affidavit submitted by Plaintiffs in support of their motion, as well as the Briefs submitted by both Plaintiffs and Defendant, and having heard the oral argument of counsel, and for the reasons set forth in the Court's opinion dated April 8, 1985,

IT IS on this 6th day of May, 1985

ORDERED that the Defendant's Motion to Dismiss Plaintiffs' Complaint be denied and that, on Plaintiffs' Motion for Summary Judgment, Summary Judgment be awarded in favor of the Plaintiffs and against the Defendant in the amount of $546,153, together with (a) interest on $261,153 of such $546,153 to be calculated from March 15, 1982 at the statutory rates of interest provided in 28 U.S.C. § 2411 for income tax refunds and (b) interest on $285,000 of such $546,153 to be calculated from June 15, 1982 at the statutory rates of interest provided in 28 U.S.C. § 2411 for income tax refunds, interest to continue after the entry of judgment at the statutory rates of interest provided in 28 U.S.C. § 2411 for income tax refunds, plus costs.

/s/ Dickinson R. Debevoise

I hereby consent to the
form of this Order

MEYNER AND LANDIS
Attorneys for the Plaintiffs

By: /s/ John N. Malyska

W. HUNT DUMONT
United States Attorney

/s/ Robert L. Handros
Trial Attorney—Tax Division
U.S. Dept. of Justice

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 85-5432

RICHARD DRAYTON, JOHN R. SAUERTEIG and SYDNEY G. STEVENS as escrow agents of THE DELAWARE & BOUND BROOK RAILROAD COMPANY,

*Appellee*

v.

THE UNITED STATES OF AMERICA,

*Appellant*

SUR PETITION FOR REHEARING

Present: ALDISERT, *Chief Judge,* SEITZ, ADAMS, GIBBONS, WEIS, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON AND MANSMANN, *Circuit Judges,*

The petition for rehearing filed by Richard Drayton, John R. Sauerteig and Sydney G. Stevens as escrow agents of The Delaware & Bound Brook Railroad Company, *appellees,* in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service

not having voted for rehearing by the court en banc, the petition for rehearing is DENIED.

BY THE COURT:

/s/ Edward R. Becker
Circuit Judge

DATED: October 7, 1986

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HONORABLE DICKINSON R. DEBEVOISE

Civil Action No. 84-3418-D

RICHARD DRAYTON,

Plaintiff,

v. ORDER

THE UNITED STATES OF AMERICA, et al.,
Defendant.

(Original Filed November 7, 1986)

The matter having been opened to the Court by Thomas W. Greelish, United States Attorney, attorney for defendant, United States of America, for an order on the mandate from the United States Court of Appeals filed October 20, 1986, and good cause having been shown,

IT IS on this 3rd day of October, 1986,

ORDERED that the judgment of the District Court entered May 7, 1986 is reversed and remanded to the U.S. District Court, with costs taxed in the sum of $59.40 in favor of defendant, United States of America, and against plaintiffs, Richard Drayton, John R. Sauerteig and Sydney G. Stevens, as escrow agents of The Delaware & Bound Brook Railroad Company.

/s/ Dickinson R. Debevoise

26 U.S.C. § 374

*GAIN OR LOSS NOT RECOGNIZED IN CERTAIN RAILROAD REORGANIZATIONS*

(a) *Exchanges by corporations.*

(1) *Nonrecognition of gain or loss.* No gain or loss shall be recognized if property of a railroad corporation, as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205), is transferred after July 31, 1955, in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership proceeding, or

(B) in a proceeding under section 77 of the Bankruptcy Act,

to another railroad corporation (as defined in section 77(m) of the Bankruptcy Act) organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other railroad corporation.

(2) *Gain from exchanges not solely in kind.* If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by paragraph (1) to be received without the recognition of gain, but also of other property or money, then—

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not

in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(3) *Loss from exchanges not solely in kind.* If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

* * *

(c) *Exchanges under the final system plan for ConRail.*

(1) *In General.* No gain or loss shall be recognized if, in order to carry out the final system plan, rail properties of a transferor railroad corporation are transferred to the Consolidated Rail Corporation (or any subsidiary thereof) pursuant to an order of the special court under section 303 or 305(d) of the Regional Rail Reorganization Act of 1973 in exchange solely for stock of the Consolidated Rail Corporation, securities of such Corporation, certificates of value of the United States Railway Association, or any combination thereof.

(2) *Exchanges not solely in kind.* If paragraph (1) would apply to an exchange if it were not for the fact that the property received in exchange consists not only of property permitted by paragraph (1) to be received without the recognition of gain or loss, but also of other property or money, then rules similar to the rules set forth in paragraph (2) or (3) of subsection (a) (whichever is appropriate) shall be applied.

(3) *Basis.* The basis of the property transferred to the Consolidated Rail Corporation (or any subsidiary thereof) in an exchange to which paragraph (1) or (2) applies shall be determined under rules similar to the rules set forth in subsection (b)(1).

(4) *Denial of net operating loss carryovers to Con-Rail.* Neither the Consolidated Rail Corporation nor any subsidiary thereof shall succeed to any net operating loss carryover of any transferor railroad corporation.

(5) *Definitions.* For purposes of this subsection—

(A) *Rail properties.* The term "rail properties" means rail properties within the meaning of paragraph (12) of section 102 of the Regional Rail Reorganization Act of 1973.

(B) *Transferor railroad corporation.* The term "transferor railroad corporation" means a corporation which, on March 11, 1976, was—

(i) a railroad in reorganization (within the meaning of paragraph (14) of section 102 of the Regional Rail Reorganization Act of 1973) in the region (within the meaning of paragraph (15) of such section 102), or

(ii) a corporation leased, operated, or controlled by such a railroad in reorganization.

(C) *Final system plan.* The term "final system plan" means the final system plan (within the meaning of paragraph (6) of section 102 of such Act). Such term includes supplemental transactions under section 305 of such Act.

(D) *Subsidiary.* The term "subsidiary" means any corporation 100 percent of whose total combined voting shares are, directly or indirectly, owned or controlled by the Consolidated Rail Corporation.

45 U.S.C. § 746.

*CERTIFICATES OF VALUE*

(a) *General*

On the date when the Corporation is required to deposit securities with the special court pursuant to section 743(a)(1) of this title, the Association shall deposit with the special court the certificates of value of the Association required by this section. The Secretary shall guarantee the payment of all certificates of value delivered in accordance with this subchapter. All guarantees entered by the Secretary under this section shall constitute general obligations of the United States of America for the payment or redemption of which its full faith and credit are pledged. Such guarantees shall be valid and incontestable except as to mutual mistake of fact or as to fraud or material misrepresentation by the holder of such certificates or the transferor of rail properties to which certificates of value of any series so guaranteed are issued.

(b) *Number and distribution*

A separate series of certificates of value shall be issued to each railroad in reorganization in the region and each person leased, operated, or controlled by such a railroad that transfers rail properties to the Corporation or a subsidiary thereof. The number of certificates of value of each series to be deposited pursuant to subsection (a) of this section shall be equal to the number of shares of series B preferred stock of the Corporation which are required to be deposited by the Corporation with the special court, pursuant to section 743(a)(1) of this title in exchange for the rail properties transferred to the Cor-

poration or a subsidiary thereof by such transferor. Certificates of value of the appropriate series shall be distributed by the special court, pursuant to section 743(c)(4) of this title, at the same time to the same transferors, and in the same numbers of units as shares of such series B preferred stock are distributed to such transferor.

(c) *Redemption*

(1) Certificates of value, of any series, shall be redeemed by the Association on December 31, 1987, or on such earlier date as the Board of Directors of the Association and the Finance Committee jointly may determine and specify.

(2) Each certificate of value of each series shall be redeemable for an amount, payable in cash, equal to its base value on the redemption date, minus—

(A) the sum of the fair market value of the series B preferred stock applicable to such certificate, the fair market value of the common stock applicable to such certificate, and all cash dividends theretofore paid on any such series B preferred stock and on any such common stock; and

(B) any sums paid to a transferor of rail properties to whom such series of certificates of value was issued resulting from sales or leases by the Corporation of properties transferred to it by such transferor divided by the number of certificates of value distributed to such transferor.

(3) The number of shares of series B stock and common stock applicable to each certificate of value of any series, pursuant to paragraph (2) of this subsection, shall be;

(A) one share of series B preferred stock (adjusted to reflect any stock splits, stock combinations, reclassifications or similar transactions affecting the number of shares of outstanding series B preferred stock following the date of distribution pursuant to section 743(c)(4) of this title); and

(B) the number of shares of common stock determined by dividing the total number of shares of common stock distributed pursuant to section 743(c)(4) of this title to the transferor receiving such series of certificates of value (adjusted to reflect any stock splits, stock combinations, reclassifications, or similar transactions affecting the number of shares of outstanding common stock following the date of distribution pursuant to section 743(c)(4) of this title) by the total number of certificates of value in the series so distributed to such transferor.

(4) The base value of each certificate of value of any series shall be the value obtained by (A) taking the net liquidation value, as determined by the special court, to which the transferor to whom such series of certificates of value is issued is entitled by virtue of transfers of rail properties, under section 743(b)(1) of this title to the Corporation or a subsidiary thereof; (B) subtracting the value of other benefits provided under this chapter, as determined by the special court; (C) adding such amount, if any, as the special court may determine shall be required after taking into consideration compensable unconstitutional erosion, if any, in the estate of a railroad in reorganization, or of a railroad leased, operated, or controlled by such a railroad, which the special court finds to have occurred during any bankruptcy proceeding with respect to such railroad; (D) adding interest from the transfer date to the redemption date to be compounded annually at a rate of 8 percent per annum; and (E) di-

viding the resulting value by the number of certificates of value of such series distributed to such transferor. In determining such base value, the special court shall give due weight and consideration to the finding of the Association as to the net liquidation value to which each transferor is entitled by virtue of conveyances of rail properties under section 743(b)(1) of this title. For purposes of this paragraph, the term "rail properties" includes all rights with respect to employee benefit plans transferred and assigned to the Corporation pursuant to section 743(b)(6) of this title. Net liquidation value with respect to such rights shall be determined after taking into account all obligations finally transferred or assigned to the Corporation pursuant to such section.

(5) The fair market value of series B preferred stock and of common stock of the Corporation shall be determined in accordance with regulations prescribed by the Association, on the basis of the average price of each such security in the primary established market in which such securities are traded over a period of 120 consecutive trading days ending not less than 20 nor more than 40 trading days preceding the redemption date, or, in the case of a security for which there is not an established trading market, on the basis of the fair market value thereof as determined by the majority vote of three experts in the valuation of securities, one to be selected by the Association, one to be selected by the directors of the Corporation elected by the holders of the security to be valued, and one to be selected by the two first selected.

(d) *Authorization of appropriations*

There are authorized to be appropriated to the Secretary such sums as are necessary to discharge the obligations of the United States arising under this section.

Supreme Court, U.S.
FILED
APR 10 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1119

# In the Supreme Court of the United States

OCTOBER TERM, 1986

RICHARD DRAYTON, ET AL., PETITIONERS

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

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*Solicitor General*

ROGER M. OLSEN
*Assistant Attorney General*

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*Department of Justice*
*Washington, D.C. 20530*
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## QUESTION PRESENTED

Whether the receipt in 1981 of the interest component of Certificates of Value, which were delivered to the Delaware and Bound Brook Railroad Company (D&BB) as compensation for the D&BB's transfer of its rail properties to the Consolidated Rail Corporation (Conrail) in 1976, constituted ordinary income taxable under Section 61(a) of the Internal Revenue Code.

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# In the Supreme Court of the United States

OCTOBER TERM, 1986

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No. 86-1119

RICHARD DRAYTON, ET AL., PETITIONERS

*v.*

UNITED STATES OF AMERICA

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

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## BRIEF FOR THE UNITED STATES IN OPPOSITION

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A29) is reported at 801 F.2d 117. The opinion of the district court (Pet. App. A30-A40) is reported at 632 F. Supp. 95.

### JURISDICTION

The judgment of the court of appeals was entered on September 11, 1986. A timely petition for rehearing was denied on October 7, 1986 (Pet. App. A43-A44). The petition for a writ of certiorari was filed on January 5, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Petitioners are escrow agents of the Delaware and Bound Brook Railway Company ("D&BB"). In 1879, the D&BB leased all of its rail properties to the Reading Company for a period of 990 years. By 1973, the Reading Company, along with other major Northeast and Midwest railroads, was in bankruptcy reorganization proceedings. Congress addressed the railroad crisis and superseded the normal reorganization process by passing the Regional Rail Reorganization Act of 1973 (Rail Act), 45 U.S.C. 701, in a comprehensive effort to save the Nation's railway system. The D&BB was affected by the Rail Act because of its long-term lease with the bankrupt Reading Company. Pet. App. A3, A9.

The Rail Act established a non-profit government corporation (the United States Railway Association, or USRA), a for-profit private corporation (the Consolidated Rail Corporation, or Conrail), and a special three-judge court (the Special Court). Under the Rail Act, USRA was charged with developing and implementing a Final System Plan for restructuring the railroads into a financially self-sustaining rail system. The Final System Plan was to provide for the transfer of certain of the properties of the bankrupt railroads to Conrail. In exchange, the railroads whose properties were transferred were to receive common and preferred Conrail stock, plus up to $500 million of USRA obligations guaranteed by the United States. Pet. App. A3.

The bankrupt railroads' major creditors challenged the constitutionality of the Rail Act, principally on the ground that the transfer of the rail properties was an unconstitutional taking without just compen-

sation. In the *Regional Rail Reorganization Act Cases* (*Rail Act Cases*), 419 U.S. 102 (1974), this Court upheld the constitutionality of the Rail Act. With respect to the taking claim, the Court explained that the existence of a remedy under the Tucker Act, 28 U.S.C. 1491, precluded a finding that there was no just compensation. 419 U.S. at 148-149.

Thereafter, Congress took action to forestall a possible flood of Tucker Act suits by amending the Rail Act. The Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act), Pub. L. No. 94-210, 90 Stat. 31, changed the manner of compensating the transferor railroads. Instead of simply depositing Conrail stock with the Special Court, the 4R Act required Conrail to deposit both Conrail stock and Certificates of Value (CVs) issued by USRA. See Pet. App. A5. It is these CVs that are the focus of this litigation.

The CVs were guaranteed by USRA and were subject to redemption by USRA on December 31, 1987, or at such earlier time as USRA might determine (Pet. App. A6). Each CV had a "base value" that was to be determined as follows (45 U.S.C. 746 (c)(4) (emphasis added)):

> (A) taking the net liquidation value, as determined by the special court * * *;
>
> (B) subtracting the value of other benefits provided under this [Act] as determined by the special court;
>
> (C) adding such amount, if any, as the special court may determine shall be required after taking into consideration compensable unconstitutional erosion, if any * * *;
>
> (D) *adding interest from the transfer date to the redemption date to be compounded annually at a rate of 8 percent per annum*; and

(E) dividing the resulting value by the number of certificates of value of such series distributed to such transferor.

In short, the redemption price for the CVs was to be the difference between the liquidation value of the transferor's assets and the value of any other compensation given to the transferor, plus an interest adjustment. The CVs were intended to make up for any shortfall in the compensation provided by the original Rail Act that would result from the low value of the Conrail stock and USRA bonds. The CVs thus were designed to ensure that all transferors received their constitutional due without the need for bringing a Tucker Act suit against the United States. See Pet. App. A8.[1]

Thereafter, Conrail continued to be dependent upon federal assistance, and its stock remained virtually worthless. On August 13, 1981, in response to this poor performance, the Rail Act was amended again. This amendment provided that all Conrail stock should be transferred to the Secretary of Transportation and that such stock should be deemed to have zero value for purposes of computing the amount for which CVs were redeemable under the Rail Act. Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 1167, 95 Stat. 686 (codified at 45 U.S.C. 1115). As a result of this legislation, ownership of

[1] At the same time that Congress passed the 4R Act it also enacted the Act of March 31, 1976, Pub. L. No. 94-253, § 1(a), 90 Stat. 295, which added Section 374(c) to the Internal Revenue Code (26 U.S.C.). Section 374(c) states that no gain or loss shall be recognized by a transferor railroad corporation upon its receipt of Conrail stock and CVs in exchange for its transfer of rail properties to Conrail pursuant to the Final System Plan.

Conrail was vested exclusively in the federal government, and CVs became the sole source of payment from Conrail to the transferor railroads. See Pet. App. A9.

2. Pursuant to the Final System Plan, the D&BB's rail property was transferred to Conrail on April 1, 1976. Thereafter, USRA estimated the net liquidation value of the D&BB's rail property to be about $1,150,000. The D&BB did not accept that figure, however, and it filed a complaint with the Special Court. In August 1981, shortly after the Omnibus Budget Reconciliation Act of 1981 was passed, the D&BB and USRA entered into a settlement agreement regarding the litigation in the Special Court. In accordance with that agreement, the D&BB received CVs having a total worth ("Base Value") of $6,802,660. This "Base Value" figure consisted of two components—the "Principal Amount of CVs" ($4,408,417) and "CV Interest" ($2,394,243).[2] The "Principal Amount" component represented the "net liquidation value" of the D&BB's rail properties on April 1, 1976, the date on which those properties were transferred to Conrail. The "CV Interest" com-

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[2] The D&BB and USRA agreed that "the value of other benefits" (VOB) conferred by the Act was zero and that there had been no "compensable unconstitutional erosion" (CUE). See 45 U.S.C. 746(c)(4)(B) and (C). Pursuant to the formula set forth in 45 U.S.C. 746(c)(4), therefore, the settlement agreement computed the "Base Value" of the CVs as follows (C.A. App. 49):

| Net Liq. Value | VOB | CUE | Principal Amount of CVs | CV Interest (As of 11/15/81) | Base Value of CVs (As of 11/15/81) |
|---|---|---|---|---|---|
| $4,408,417 | -0- | -0- | $4,408,417 | $2,394,243 | $6,802,660 |

ponent represented 8% annual interest on the "Principal Amount" component, accruing from the transfer date of the rail properties until the redemption date of the CVs. See 45 U.S.C. 746(c)(4)(A) and (D); Pet. App. A10-A11.

In November 1981, USRA redeemed the CVs held by the D&BB for the full $6,802,660. After sharing part of this money with the Reading Company, its lessee, the D&BB liquidated its assets and distributed the proceeds to its shareholders pursuant to Section 337 of the Internal Revenue Code.[3] The D&BB subsequently sought two separate private letter rulings from the IRS concerning the interest component of the CVs. The D&BB claimed that this component was partial payment for the transferred rail property, thus constituting a return on capital that should be taxed as a capital gain. The IRS disagreed, however, and ruled that the interest component represented ordinary interest income taxable to the D&BB under Section 61(a)(4) of the Code. The IRS also disagreed with the D&BB's suggestion that the interest component should be eligible for nonrecognition treatment under Section 337 of the Code. Pet. App. A11-A12.

In accordance with these letter rulings, the D&BB reported the interest component of the CVs as ordinary income and paid the tax thereon. Subsequently, it filed an amended return seeking a refund of the taxes paid. Following the disallowance of that claim by the IRS, petitioners, as escrow agents of the D&BB, brought this refund suit on its behalf in the

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

United States District Court for the District of New Jersey. Pet. App. A12.

The district court granted summary judgment in favor of the D&BB (Pet. App. A30-A40). The court reasoned that the interest component of the CVs was "an integral part of the redemption, or base, value for rail properties," and was "not an amount in excess of the value of such properties" (*id.* at A39). Accordingly, it concluded that "[u]nder the express provisions of [I.R.C.] § 374(c), the aggregate sum received should result in no tax consequences to D&BB" (*ibid.*).

The court of appeals unanimously reversed (Pet. App. A1-A29). Relying in part on this Court's decision in *Kieselbach* v. *Commissioner*, 317 U.S. 399 (1943), the court of appeals held that the interest component of the CVs represented payment for the detention of money between the 1976 transfer date and the 1981 redemption date, and therefore fell squarely within the standard definition of interest. It accordingly concluded that the payment must be treated as ordinary interest income under Section 61(a)(4) of the Code. Pet. App. A14-A17.

## ARGUMENT

The court of appeals correctly held that the interest component of the CVs is taxable as "interest" income under Section 61 of the Code. The court's decision does not conflict with any decision of this Court or of another court of appeals. The issue presented has little future significance because it concerns the proper characterization of a payment made under a unique, one-time program that is not likely to be repeated. Indeed, petitioner does not cite a single case, apart from this one, that has ever ad-

dressed the tax treatment of the interest component of the CVs. There is accordingly no need for further review.

1. Section 61(a)(4) of the Code provides that "gross income means all income from whatever source derived, including * * * interest." Congress has not used the term "interest" in the Internal Revenue Code with reference to "some esoteric concept derived from subtle and theoretic analysis." *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 561 (1932). Rather, the term "interest" has a definite and long accepted meaning as the "compensation allowed by law or fixed by the parties for use, or forbearance, or detention of money" (*Fall River Electric Light Co.* v. *Commissioner*, 23 B.T.A. 168, 171 (1931) (citations omitted)). See, *e.g.*, *Deputy* v. *DuPont*, 308 U.S. 488, 498 (1940); *In re Timbers of Inwood Forest*, 793 F.2d 1380, 1382 n.1 (5th Cir. 1986); *Coldwater Seafood Corp.* v. *Commissioner*, 69 T.C. 966, 972 (1978); see also Treas. Reg. § 1.61-7. And the categories of income contained in Section 61 generally have been given a broad reading, with exemptions therefrom recognized only when specifically authorized by Congress. See *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430 (1955).

On the other hand, this Court has long held that a narrow construction is to be accorded "capital asset," the term that petitioner asserts should encompass the interest component of the CVs at issue here. This rule accords with Congress's intent to afford capital gains treatment only where the taxpayer has realized an appreciation in value that has accrued over a substantial period of time. See *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960). Accordingly, this Court has consistently construed the term "capital asset" to exclude prop-

erty that represents either an item of income or an accretion to the value of an asset that is properly attributable to income. See *Commissioner* v. *Gillette Motor Transport, supra* (compensation awarded for rental value of facilities during period of government control taxed as substitute for rental income); *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) (gain attributable to original issue discount taxed as disguised interest income); *Hort* v. *Commissioner*, 313 U.S. 28 (1941) (amounts received for cancellation of lease taxed as substitute for rental income).

In *Kieselbach* v. *Commissioner*, 317 U.S. 399 (1943), the Court addressed a situation closely analogous to that presented here. The City of New York had instituted a condemnation proceeding in which payment was made several years after the actual taking. The payment consisted of two components, one representing the value of property at the time of the taking and the other representing interest. *Id.* at 400. The Court held that the interest component was fully taxable as ordinary income under the predecessor of Section 61(a)(4). The taxpayer had urged that the interest component was taxable as capital gain because the relevant state law provided that interest was part of the total condemnation award to which the property-owner was entitled. In rejecting that argument, this Court stated that the interest payment was "indemnification for delay, not a part of the sale price" of a capital asset. 317 U.S. at 404.

Similarly here, the interest component of the CVs in question was paid under a statutory formula that expressly provided for "interest from the transfer date to the redemption date * * * compounded an-

nually at a rate of 8 percent per annum." 45 U.S.C. 746(c)(4)(D). In contrast to true capital appreciation, the interest component here was predictable and measurable in advance, and it represented compensation for the detention or forbearance of money. If full payment for the rail properties had been made on the transfer date, this interest component would obviously have been zero. Thus, the payment represented "income * * * paid to the [D&BB] in lieu of what [it] might have earned on the sum found to be the value of the property on the day the property was taken." *Kieselbach* v. *Commissioner*, 317 U.S. at 403. In these circumstances, the court of appeals was clearly correct in holding that the interest component received by the D&BB on the CVs constituted ordinary interest income taxable under Section 61(a)(4) of the Code.

2. Petitioners contend (Pet. 13-20) that the decision below is inconsistent with this Court's decision in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974). This contention is without merit. In the *Rail Act Cases*, the Court upheld the constitutionality of the Rail Act on the ground that the availability of a Tucker Act remedy ensured that the transferors would receive just compensation for their properties even if it turned out that the Conrail stock and USRA bonds that they received in exchange were not themselves adequate. The Court held that "[a]s long as creditors are assured fair value, with interest, for their properties, the Constitution requires nothing more" (*id.* at 156). Petitioners here have received "fair value, with interest, for their properties" (*ibid.*), and this case accordingly presents no constitutional claim. Rather, the sole question here concerns the proper treatment, for federal

income tax purposes, of the interest that petitioners received. Since the Court in the *Rail Act Cases* did not address any income tax questions, and since the particular instruments at issue here—CVs with both "principal" and "interest" components—were not even created by Congress until several years after this Court decided the *Rail Act Cases*, it is difficult to see how that decision could reasonably be said to conflict with the decision below.

The gist of petitioners' contention in this regard appears to be that the Court in the *Rail Act Cases* viewed the Rail Act as effecting an "*exchange* in furtherance of a plan of reorganization" (Pet. 13 (emphasis in original)), rather than a public condemnation that required full and immediate cash payment for the rail properties (see 419 U.S. at 149-150). From this premise, petitioners deduce that the CVs, including the interest component, are indivisible assets received in an exchange of property. The interest component, petitioners argue, should be viewed merely as "growth" in the value of those assets and therefore eligible for capital gain treatment. See Pet. 13-14.

This contention misses the mark for several reasons. To begin with, petitioners' contention ignores the fact that the compensation mechanism involved here is not the same as the one before the Court in the *Rail Act Cases*. Three years after the *Rail Act Cases* were decided, the 4R Act created the government-guaranteed CVs at issue here, requiring USRA to deposit them with the Special Court to fill any gap in compensation caused by the low value of the Conrail stock and USRA bonds (see Pet. App. A5-A8; 45 U.S.C. 746(a)). In 1981, the statute was amended again; the Conrail stock was deemed to

have zero value and 100% of that stock was transferred to the government, with the result that the CVs became the sole source of payment from Conrail to the transferor railroads. 45 U.S.C. 1115. Thus, after 1981, the concept that part of the compensation for the transfer of the rail properties would take the form of equity in a private corporation was no longer operative. In the end, petitioners received no equity; and the fact that there was no "growth" in the value of their railroad assets was clearly demonstrated by the decline in the value of the Conrail stock to zero by 1981. As the court of appeals observed (Pet. App. A22-A23), therefore, it is highly questionable whether this Court's statement in the *Rail Act Cases* characterizing the 1973 version of the Rail Act as a bankruptcy reorganization statute should be viewed as fully applicable to the revised statutory scheme at issue in the present case.

In any event, even if the Rail Act were properly characterized as a reorganization statute, the interest component of the CVs would still be subject to taxation as ordinary income. Pursuant to Section 374 of the Internal Revenue Code, the D&BB's 1976 exchange of its rail properties for CVs and Conrail stock was treated as a tax-free exchange, with no gain or loss being recognized to the D&BB at that time. At that time, of course, the value of the "interest component" of the CVs was zero. But the transaction at issue here does not concern the original 1976 exchange of assets for CVs; rather, it concerns USRA's redemption of those CVs five years later, by which time the "interest component" of the CVs had risen to $2,394,243. As the court of appeals correctly pointed out (Pet. App. A14-A15), the redemption is a wholly different transaction from the initial exchange of rail property for securities. The

government is not now seeking to impose, any more than it sought in 1976 to impose, any tax on the "principal component" of the CVs, which corresponds to the 1976 net liquidation value of the rail property. What the government seeks to tax is the interest that accrued on that principal during the subsequent five-year period. Obviously, the fact that a taxpayer has received a debt instrument in a tax-free reorganization in 1976 does not mean that the interest on that debt—either under Section 374 or under general tax principles—is perpetually immune from tax. It was the 1981 redemption of the CVs, not their receipt in the 1976 exchange, that caused them to have an interest component that is taxable to the D&BB under Section 61(a)(4). Accordingly, the decision below is fully consistent with this Court's characterization of the Rail Act as a "reorganization statute" in the *Rail Act Cases*.

By the same token, there is no merit to petitioners' contention (Pet. 16) that the reorganization aspects of the Rail Act render *Kieselbach* v. *Commissioner*, *supra*, irrelevant. There is no reason why the decision in *Kieselbach* should be limited to condemnation statutes. The two factors upon which the finding of taxability in *Kieselbach* hinged are both present here. First, the D&BB was not paid for its rail property until substantially after the transfer date. Second, as compensation for the five-year delay in payment, the D&BB received an amount over and above the 1976 value of that property—an amount computed at 8% per annum. In this case, as in *Kieselbach*, the property owner was under legal compulsion to transfer the property at a specified time and could not withhold transfer until payment was received. To compensate the owner for that delay, the ultimate cash payment included an interest component. Hence,

condemnation proceeding or not, the rationale of *Kieselbach* is fully applicable here.

Finally, we note that petitioners' theory that the interest component of the CVs represented "growth" in the value of an equity investment (Pet. 15) necessarily incorporates several illogical assumptions. First, there is no reason to suppose that Congress would have wanted to pay the transferor railroads for capital "growth" after the transfer of their railroad property. Second, petitioners' theory irrationally presupposes that the D&BB and the other transferors gave Conrail free use of their money for an indefinite period subsequent to the conveyance date. Third, as noted above, the D&BB never received any equity investment and, even if it had received one, the "growth" in value would have been negative, since the value of the Conrail stock, at the time it was transferred to the government in 1981, was zero. The interest component of the CVs must therefore be characterized as "interest" income under Section 61(a)(4) of the Code, just as Congress denominated it. See *Starker* v. *United States*, 602 F.2d 1341, 1356 (9th Cir. 1979) (six-percent "growth" factor in land exchange agreement held to constitute disguised interest income, not capital gain).[4]

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[4] Petitioners also contend (Pet. 16-24) that the court of appeals erred in failing to recognize that the D&BB had a legal and equitable right to receive compensation in the form of Conrail stock, as contemplated in the original Rail Act. It is not apparent how this contention supports petitioners' ultimate view that the interest component of the CVs should not be taxed. Even if petitioners had some legitimate expectation of compensation in the form of equity, which the court of appeals correctly held they did not (see Pet. App. A26-A28), that would not affect the taxability of the CVs that they actually received. It is well established that a transaction is

3. Contrary to petitioners' assertion (Pet. 26-28), the decision below does not conflict with the decision in *Commissioner* v. *Carman*, 189 F.2d 363 (2d Cir. 1951). In *Carman*, the taxpayer bought certain railroad bonds, the interest on which had been in default since 1933. In 1935, the railroad filed a petition for reorganization under the Bankruptcy Act, and in 1939 a plan was approved by the district court. Consummation of the plan was delayed for five more years by litigation, however, and it was not until December 29, 1944, that the plan went into effect. On that date, the taxpayer surrendered his bonds and received in exchange new bonds, preferred stock, common stock, and cash. The cash represented "adjustment payments" to compensate the taxpayer for the five-year delay between the development of the plan and its consummation. See 189 F.2d at 364. Although the Tax Court held that the "adjustment payments" were taxable to the taxpayer as ordinary income, the court of appeals reversed, holding that such payments were received as part of the reorganization plan and were taxable as "boot," not as ordinary income.

As the court of appeals correctly noted (Pet. App. A24 n.9), the decision in *Carman* is not in conflict with the decision below because it turned on factors not present here. The taxpayer in *Carman* had full control over his bonds between 1939 and 1944; he could have transferred them or sold them at will. He did not exchange his bonds until 1944, at which time he was paid in full when he received new bonds,

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to be given its tax effect "in accord with what actually occurred and not in accord with what might have occurred." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974).

stock, and cash. Because there was no post-exchange delay in the taxpayer's receipt of this consideration, the entire consideration received was logically viewed as being received in exchange for the property surrendered. There was thus no occasion in *Carman* to find any "interest component" in the transaction. Here, by contrast, the D&BB gave up all rights to its property in April 1976, and it did not receive any cash in exchange for that property until 1981. The "interest component" attributable to that delay in receiving payment was correctly treated as interest income.[5]

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1987

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[5] In addition, we note that *Carman* was decided prior to the enactment of the unstated interest provisions of Section 483 of the Code. The courts of appeals, including the Second Circuit, have consistently held that interest is imputed under that provision in cases involving delays with respect to the issuance of securities in reorganizations. *Kingsley* v. *Commissioner*, 662 F.2d 539 (9th Cir. 1981); *Vorbleski* v. *Commissioner*, 589 F.2d 123 (3d Cir. 1978); *Solomon* v. *Commissioner*, 570 F.2d 28 (2d Cir. 1977); *Jeffers* v. *United States*, 556 F.2d 986 (Ct. Cl. 1977). The result in *Carman*, therefore, might well be different if it were decided today.

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